

HONG KONG AND SEOUL CBD RENTS VULNERABLE TO FALLING STOCK MARKETS

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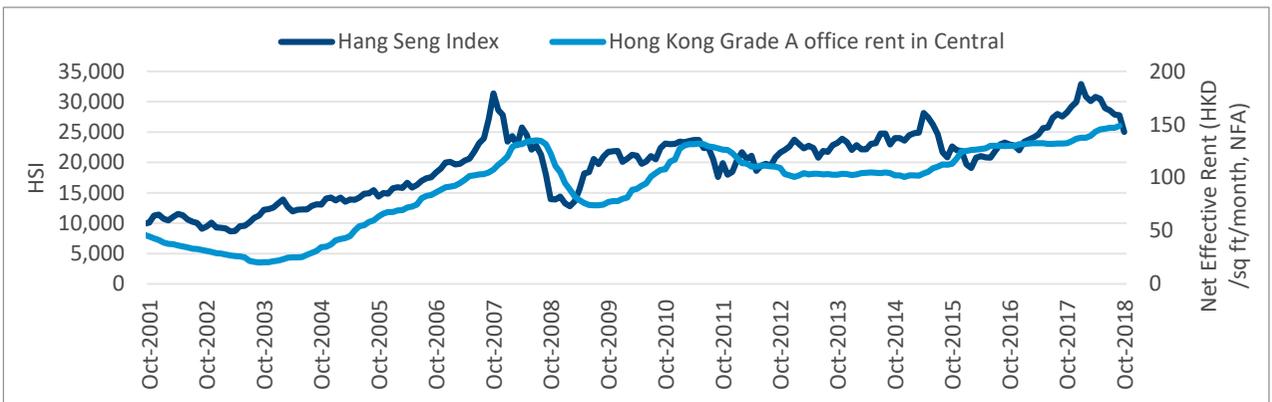
Summary & Recommendations

Among Asia's leading financial centres, the relationship between the level of the stock market and Grade A office rents in CBDs is closest in Hong Kong, followed by Seoul. The relationship is weaker in Shanghai and Singapore, and weakest of all in Tokyo.

We now expect a lagging effect of the 22% drop in Hong Kong's Hang Seng Index from its 2018 high to be a 4% decline in rents in Hong Kong Central in 2019. Our already cautious forecasts for rents in Seoul's CBDs also look liable to downward revision.

In contrast, Shanghai's economy looks broad enough to withstand financial shocks. The uptrend in rents in Singapore should persist due to tight vacancy and muted supply. In Tokyo, likewise, firm demand, limited supply and very low vacancy should underpin rent growth in the near term at least.

Hong Kong's Hang Seng Index and Grade A office rents in Central



Source: Bloomberg, Colliers International

Hong Kong: Financial stocks have a 48% weighting in the Hang Seng Index, while financial tenants occupy 54% of Grade A office space in the CBD. Hong Kong shows the highest correlation in Asia between stock market level and rents. This explains our new forecast of a 3.8% drop in rents in Central/Admiralty in 2019.

Seoul: The finance sector currently has a 20% weighting in the KOSPI market, and financial tenants occupy 36% of Grade A office space in Seoul's CBDs. Seoul shows the second highest correlation between stock market performance and office rent levels. The risk to our already cautious rent forecasts is probably on the downside.

Shanghai: Finance represents 31% of the Shanghai Composite Index and 42% of Grade A office stock in the city's CBDs. However, the relationship between the stock market and rents in the key area of Lujiazui is not close. The city's economy can withstand financial shocks, and we predict 1.5% average citywide rent growth over 2018-2022.

Singapore: The finance sector represents 43% of the Straits Times Index and 45% of prime office stock in the CBDs. Nevertheless, the correlation between the stock market and rents is relatively low. Given firm market conditions, we expect prime rents to rise by 8% in 2019, and by 5% in 2020.

Tokyo: The financial sector represents 12% of the TOPIX index and about 8% of Grade A office space in the central wards. The correlation between the TOPIX and rents is very low. Tokyo's office market should continue to recover: we see rent growth peaking at 4.5% YOY within the next several quarters before tapering to under 1% over time.

Hong Kong

Colliers will shortly launch its “Top Locations in Asia (Finance)” report. This recommends the best urban locations for financial occupiers in the region by examining around 60 criteria relevant to choice of location across 16 cities. Hong Kong’s importance as a financial centre is demonstrated by its high position on measures of economic scale and wealth such as stock market value (the Hang Seng or HSI¹ equity market is the second largest in Asia after Tokyo), city inward FDI, and volume of cross-border banking liabilities.

Financial stocks have a 48% weighting in the HSI, while financial tenants occupy 54% of Grade A office space in Hong Kong’s CBD by our estimate. It should thus be little surprise that there is a clear historic relationship between the level of the HSI and average Grade A office rents in Central, with a correlation coefficient (*R*) of 0.86 and a coefficient of variation (*R*²) of 0.74. This represents the closest correlation between stock index performance and rent levels of any city in this report.

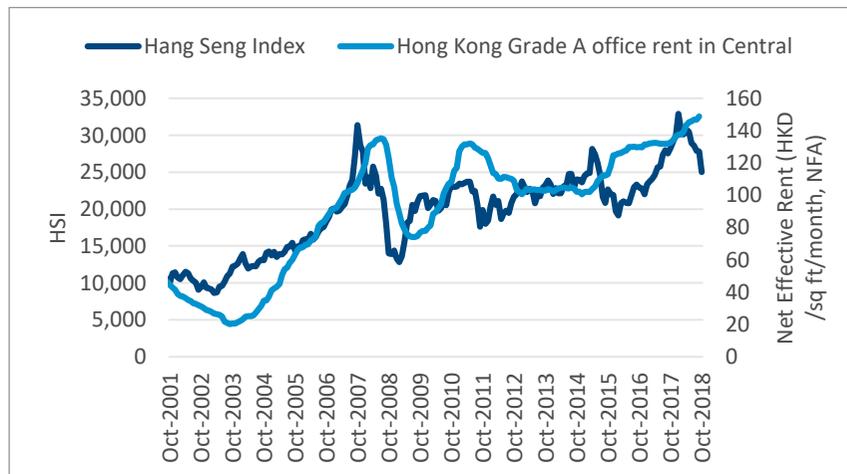
As shown in Figure 1, until recently Grade A office rents in Central followed

the HSI with a lag of six to twelve months. However, since 2015 the two measures have diverged: rents have risen steadily despite big swings in the stock market. We doubt that this divergence can continue given:

1. the HSI’s 22% fall (as of 5 November) from its January 2018 high, which must have hit the confidence of investment banks and securities firms,
2. the prospect of faster increases in real interest rates in Hong Kong than in most other Asian markets over the next three years, owing to the strong US economy and the Hong Kong dollar’s peg to the US dollar,
3. the blow to confidence in Hong Kong from the US-China trade war.

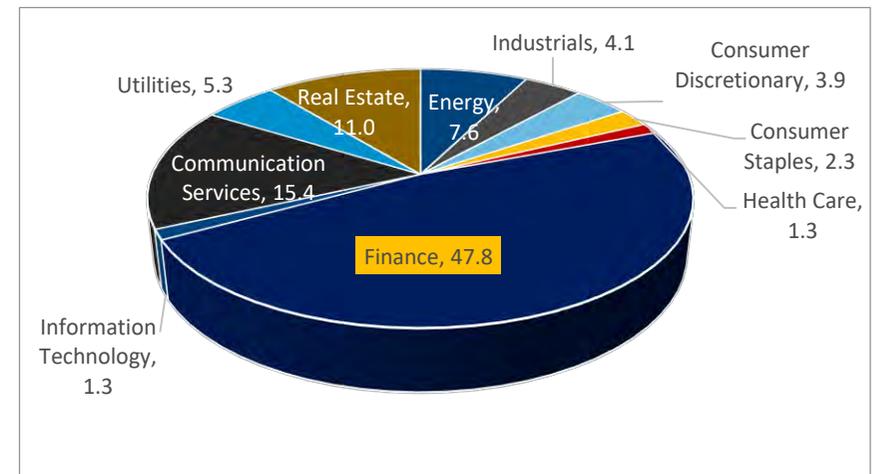
This is the background to our recent downward revision of office rent forecasts for Hong Kong. We now expect citywide average rents to stay flat in 2019 and rise at a 2.5% CAGR over 2018 to 2022. However, we expect Grade A rents in Central/Admiralty to drop by 3.8% in 2019. With few signs of major retrenchment or market exit by large international or Chinese financial firms, rents should steady thereafter.

Figure 1: Hong Kong’s HSI and Grade A office rents in Central



Source: Bloomberg, Colliers International

Figure 2: Hang Seng Index weighting scheme (%)



Source: Bloomberg, Colliers International

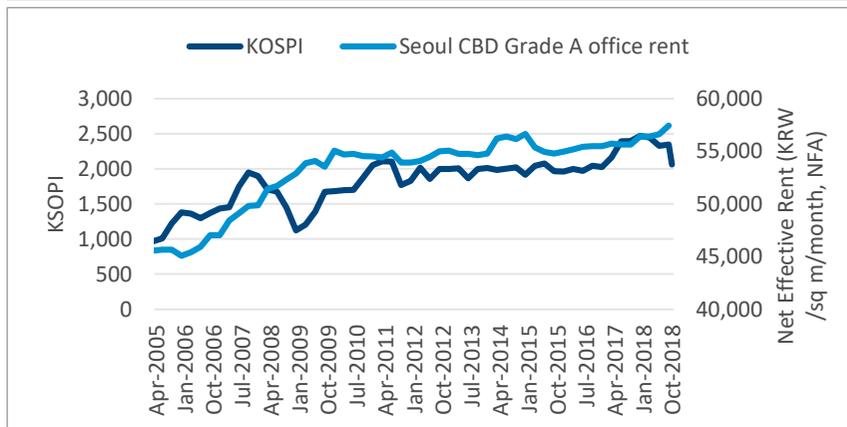
¹ Hang Seng Index is a free-float capitalisation-weighted index of a selection of companies from the Stock Exchange of Hong Kong. The components of the index are divided into four sub-indices: Commerce and Industries, Finance, Utilities, Properties.

Seoul

Seoul is an important financial centre which completely dominates its own market. Seoul accounts for 20% of the South Korean economy, and a 14% share of the city’s GDP came from the finance and insurance sector in 2017. In addition, South Korea plays a vital role in global trade, ranking fifth among the largest export economies in the world as of 2016, according to the Observatory of Economic Complexity (OEC). Notably, South Korea is the fourth largest exporter of semiconductors and the second largest exporter of semiconductor manufacturing equipment in the world.

The finance sector currently has a 20% weighting in the Korea Composite Stock Price Index¹ (KOSPI), the largest following the electrical & electronic equipment sector (28%, with Samsung Electronics alone representing over 20%). The importance of the finance sector in the Seoul office market reflects the transformation of Seoul in the past couple of decades from a traditional industrial city to a financial centre. By our estimate the finance sector now accounts for 36% of Grade A office space in Seoul’s three CBDs (the Central Business District, Yeouido Business District and Gangnam Business District).

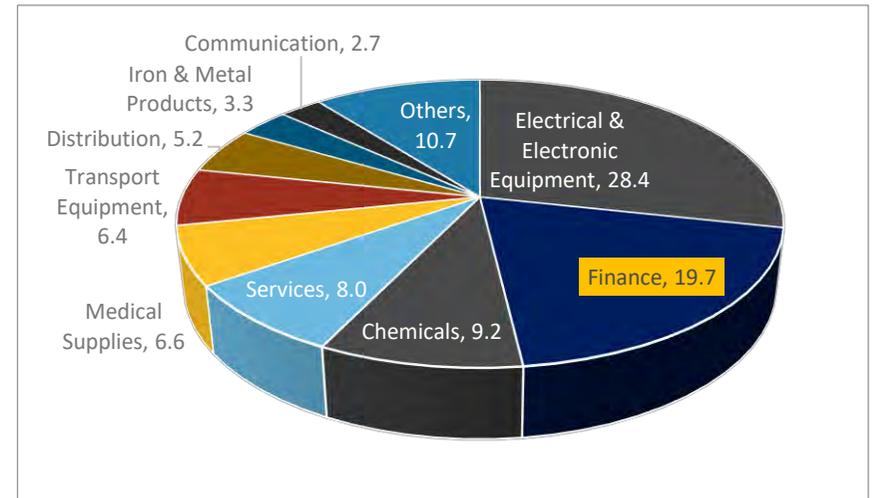
Figure 3: Seoul KOSPI Index and Grade A office rents in CBDs



Source: Bloomberg, Colliers International

¹ Korea Composite Stock Price Index is a capitalisation-weighted index of all common shares on the Korean Stock Exchanges.

Figure 4: KOSPI weighting scheme (%)



Source: Korea Exchange, Colliers International

The KOSPI has a close relationship to Grade A office rents in Seoul’s CBDs, according to the empirical result of our ANOVA statistical testing. The correlation coefficient (R) is 0.77 and the coefficient of variation (R^2) is 0.59. This represents the **second closest relationship between stock index performance and office rent levels of any city after Hong Kong** in this report. We were initially surprised by this outcome, since office rents in Seoul have been more stable than in many other Asian cities. However, the KOSPI index has also traded in a narrower range than many other Asian stock markets, notably over the years 2011-2016. We think that the relationship is genuine.

So far in 2018, the Seoul office market has been more favourable to tenants than many other Asian cities. We currently estimate a 2% rent increase linked to the CPI in average citywide rent for Seoul in 2018, with an annual increase of at most 2-3% over the next few years. In the present situation of increasing economic uncertainty and tensions over trade, **the risk to our already cautious rent forecasts is probably on the downside**. This is especially true because we continue to assume upward pressure on vacancy, notably in the Yeouido Business District (YBD), where in our view the expected supply still exceeds the district’s capacity for absorption.

Shanghai

As the financial capital of China, Shanghai has an equity market value of about USD4.0 trillion with the finance sector accounting for 18% of the city’s GDP.

In addition to its importance to the city’s GDP, [the finance sector accounts for 31% of the Shanghai Composite Index¹](#) (SHNCOMP) weighting by industry, and by our estimate for [42% of Grade A office stock in the city’s six prime CBDs](#) (Lujiazui, Zhuyuan, Huangpu, Jing’an, Xuhui and Changning). Given the importance of the financial sector in Shanghai’s economy, one might expect there to be a relationship between the equity market and office rents. However, the empirical result of our ANOVA testing suggests [the relationship between the two measures is not high](#), with a correlation coefficient (*R*) of 0.39 and a coefficient of variation (*R*²) of 0.15. Figure 5 shows that office rents in key area of Lujiazui (which we have used because the data set is longer) diverged sharply from stock market performance over 2009-2014.

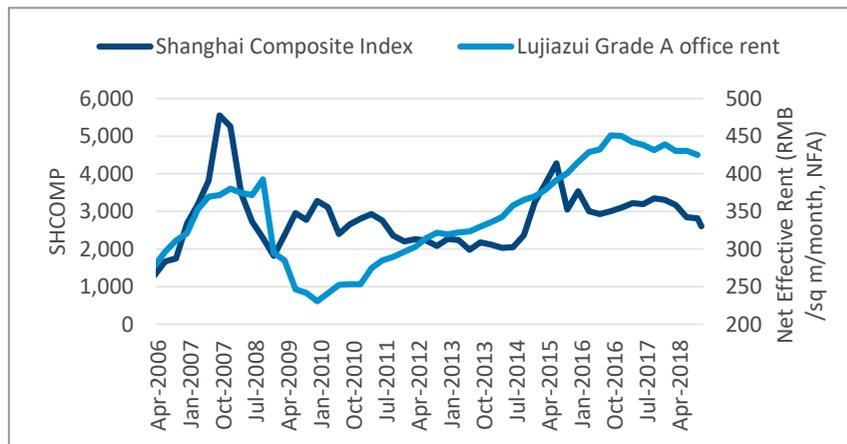
The equity market in mainland China has its own characteristics which partly reflect government efforts to keep the market stable. Stock exchanges in

China are A and B share markets. The A share market (denominated in RMB) is mostly closed to foreign investors while the B-share market (denominated in USD in Shanghai) is open to foreigners. These features help explain why Chinese stock markets can move quite differently from other big exchanges, although Chinese markets are certainly not immune to global pressures.

As Figure 9 shows, Grade A office rent in Lujiazui was in a strong upward trend between 2010 and 2016, but has drifted down since then. We assume that the confidence of financial occupiers in Shanghai has been affected by the poor performance of the Shanghai stock market (as of 5 November, down by 25% from its recent peak in early January 2018), and by the renewed weakness of the Chinese currency against the US dollar so far this year. If so, it may well be that office rents in Shanghai’s financial districts start to track the stock market more closely from now on.

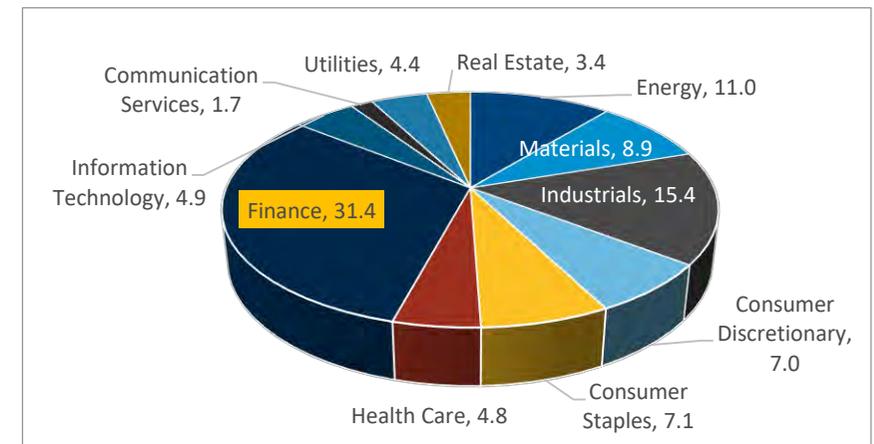
On the other hand, [the economy of Shanghai as a whole looks broad enough to withstand any shocks in the financial sector](#). We forecast average annual rent growth of 1.5% across the city’s various sub-markets over 2018-2022.

Figure 5: Shanghai Composite and Grade A office rents (Lujiazui)



Source: Bloomberg, Colliers International

Figure 6: Shanghai Composite Index weighting scheme (%)



Source: Bloomberg, Colliers International

¹ Shanghai Composite Index is a capitalisation-weighted index tracking the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

Singapore

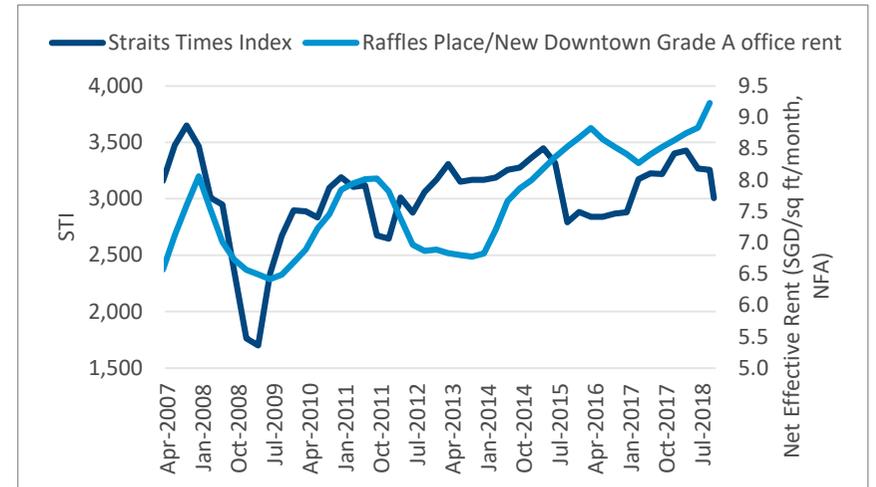
While it lacks the banking scale of Tokyo or Hong Kong, Singapore is one of Asia’s premier wealth management hubs. **The finance sector represents 43% of Singapore’s Straits Times Index¹ (STI) (see Figure 8) and 45% of prime office stock in Singapore’s CBDs** respectively. Given Singapore’s position as a small economy with very open capital markets, a high degree of foreign involvement, and close trade relations with the rest of the Asia Pacific region, one might guess that the relationship between the stock market and office rents was quite high.

However, the relationship between the STI index market and Grade A office rents in Singapore is not particularly close. This is evident from Figure 5 at right, which shows significant deviations between stock market performance and rent direction, especially in the periods between about June 2012 and June 2014, and June 2015 and March 2017. Our ANOVA testing shows a correlation coefficient (*R*) of 0.38 and a coefficient of variation (*R*²) of 0.14. **This represents a relatively low degree of correlation.**

We would suggest that the prime office market in Singapore has been less volatile than the equity market due to tightening vacancy, limited availability of quality stock available and stable rent growth since 2014. The primary drivers of rent growth in recent years have been the banking, insurance and business services sectors, as well as the wholesale and retail trade sectors. Technology groups and flexible workspace operators have also now emerged as important contributors to net absorption and therefore rent growth.

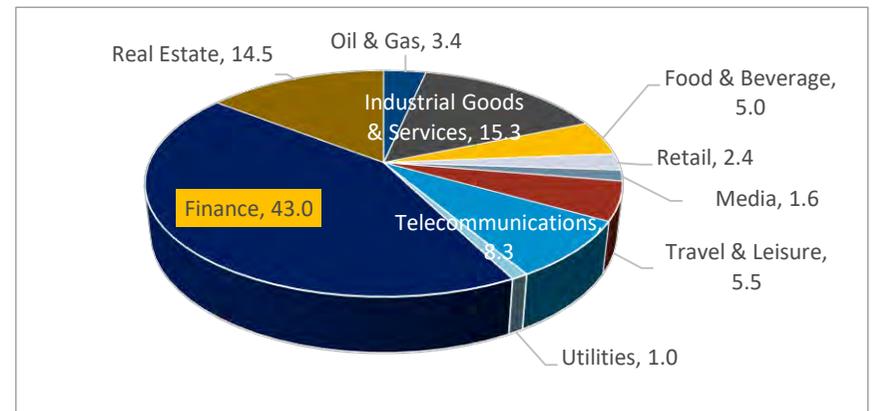
CBD Grade A rents in Singapore have recorded cumulative growth of 12.1% so far in 2018. In view of tight vacancy and muted supply, we expect the steady upward rental trend to persist over the next two years, with average rent rising an estimated 8% YOY in 2019, and a further 5% YOY over 2020. While we acknowledge the risk that our rent forecasts may prove too high if turbulence in stock markets continues and results in reduced demand from finance sector occupiers, **Singapore looks less vulnerable than Hong Kong in particular to pressure on CBD rents next year.**

Figure 7: Singapore STI and Grade A office rents in Singapore’s CBDs



Source: Bloomberg, Colliers International

Figure 8: Straits Times Index weighting scheme (%)



Source: FTSE Russell, Colliers International

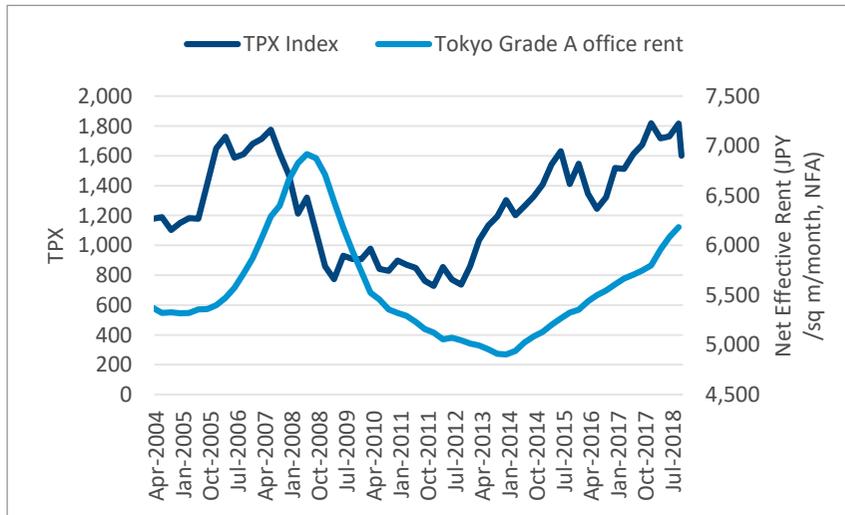
¹ Straits Times Index is a capitalisation-weighted stock market index that is regarded as the benchmark index for the Singapore stock market, constructed by Singapore Press Holdings, Singapore Exchange and FTSE. It tracks the performance of the top 30 companies listed on the Singapore Exchange.

Tokyo

Tokyo is Asia’s and the world’s largest city with a metropolitan population of 36 million and GDP of over USD2.0 trillion. Like Hong Kong, Tokyo is a global financial hub. It enjoys an ample financial buffer arising from the world’s largest net international investment position of JPY328 trillion (USD2.93 trillion) as its savings have continued to grow over the past decade. Unlike Hong Kong, Tokyo’s economic base is so large and diverse that **the financial sector accounts for only 12% of the Japanese TOPIX equity index¹ and for about 8% of Grade A office space in Tokyo’s central wards by our estimate.**

Low volatility and low correlation with stock index performance are defining characteristics of the Tokyo office markets over multiple cycles. Mapping Grade A office rents and the TOPIX equity index over the past 15 years gives a correlation coefficient (R) of 0.22 and a coefficient of variation (R²) of 0.05. This suggests **the office rents are likely to be the least impacted by stock market performance among the five major Asian cities in this report.**

Fig. 9: Tokyo TOPIX Index and Grade A office rents (top five wards)

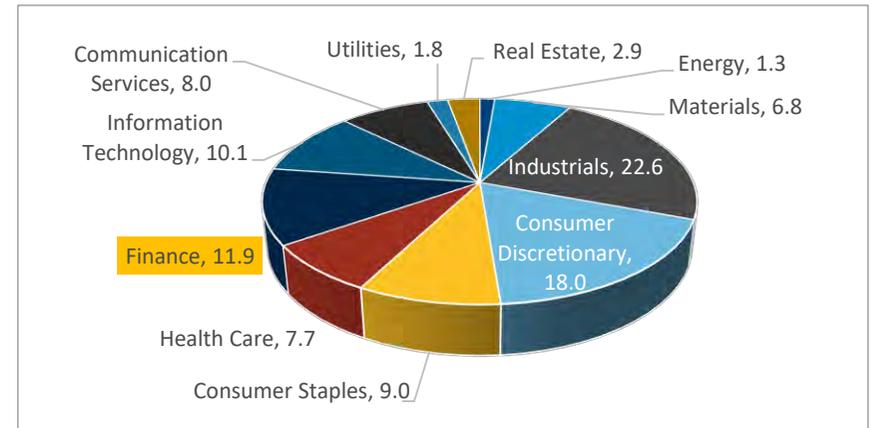


Source: Bloomberg, Colliers International

¹Tokyo Stock Price Index is a capitalisation-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The index is supplemented by the sub-indices of the 33 industry sectors.

²Mari Kumagai, “Catching The Rhythm of Tokyo” (October 2018), Colliers Japan Research.

Figure 10: TOPIX Index weighting scheme (%)



Source: Bloomberg, Colliers International

Aggressive monetary easing by the Bank of Japan has been one of the three pillars of the Abe government’s pro-growth policy platform since 2013. We expect the same policy commitment, allowing only modest interest rate increases up to 25 basis points per year at least until 2020.

Tokyo rents have been rising steadily since January 2014 as solid demand - tracking at around 2.7% of existing stock - has outstripped the negative net supply after adjusting for increasing demolition for five years in a row. We expect that record low vacancy of below 3.0% will persist with rent growth peaking at about 4.5% YOY within the next several quarters before tapering down to a more sustainable annual growth rate of 0.8%². Japan’s relatively inflexible labour system also implies low wage growth, to which office rent has displayed higher correlation reflecting corporate budgeting processes. Given low and steady real wage growth that is keeping pace with a low inflationary outlook tracking at below 1.0%, **the level of Japan’s stock market has limited direct relevance to prospects for office rent.**

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