MARKET IN MINUTES
Savills Research

Office



Shadow space market to be the focus

Activity in the office leasing market continues to be supported by renewals of leases amid a lack of significant pipeline supply of office space.

- Due to global economic challenges and a lack of significant supply, firms have largely renewed their current leases and are not as bullish in their expansion plans as before.
- Block transactions of office assets have been on the decline in recent quarters as investors become increasingly cautious due to interest rate hikes. There was only one block transaction in Q3, which was for the sale of OCN Building for S$42 million.
- The vacancy rate of CBD Grade A offices tracked by Savills continued to fall further for a second consecutive quarter by 1.2 ppts on a quarter-on-quarter (QoQ) basis to 5.6% in Q3/2022, extending the 0.4 ppt decline in Q2/2022. Contraction in vacancy rates was recorded across all three gradings of offices, particularly for Grade AA buildings, which fell 2.4 ppts QoQ. Nevertheless, there are signs of increasing shadow space. Net demand for CBD Grade A offices thus increased to 417,000 sq ft in the quarter, leading to a total net take-up of 612,000 sq ft for the first three quarters of the year.
- With declining vacancy rates and higher demand, average monthly rents of Savills basket of CBD Grade A offices increased for a third consecutive quarter by 0.3% QoQ to S$9.50 psf. This was a slightly lower rate than the 0.4% growth in Q2/2022.
- Rising conservancy charges and the need for future capital expenditure related to environmental, social and governance (ESG) matters will lead landlords pass these increases to tenants and they can do that because new Grade A CBD office supply in 2022 and 2023 is low. Our rental projection for 2022 remains at 3% year-on-year (YoY) with 2023 rents expected to increase by 2% YoY.

"Whilst global economic conditions are souring, Grade A landlords may still be able to pass on higher conservancy charges by raising rents as new supply is limited."

ALAN CHEONG, SAVILLS RESEARCH

Savills team

Please contact us for further information

SINGAPORE

Marcus Loo
CEO, Singapore
+65 6415 3893
marcus.loo@savills.com.sg

Ashley Swan
Executive Director
Commercial
+65 6415 3872
ashley.swan@savills.com.sg

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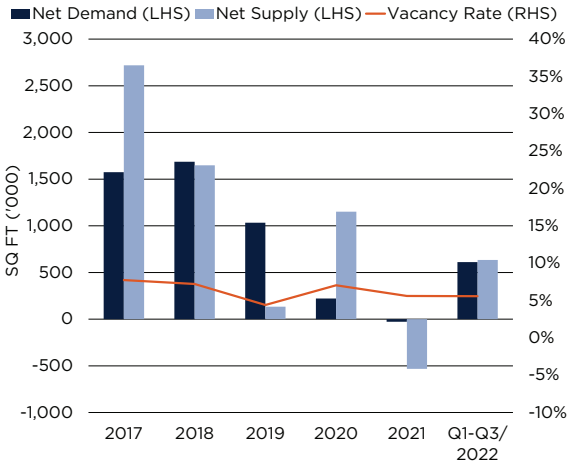
Alan Cheong
Executive Director
Singapore
+65 6415 3641
alan.cheong@savills.com.sg

Simon Smith
Regional Head of
Research & Consultancy
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk

MCI (P) No. 022/10/2020
Company Reg No. 198703410D

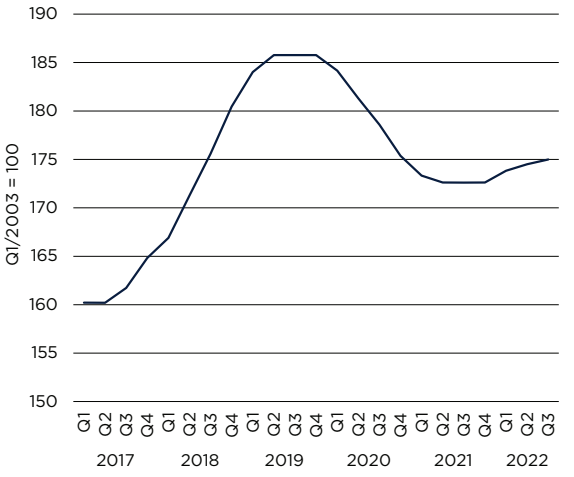
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GRAPH 1: Net Demand, Net Supply and Vacancy Rate of CBD Grade A Offices, 2017 to Q3/2022



Source Savills Research & Consultancy

GRAPH 2: Rental Indices of CBD Grade A Offices, Q1/2017 to Q3/2022



Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q3/2022

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	12.31	2.4%
Raffles Place	9.68	8.3%
Shenton Way	8.75	7.8%
Tanjong Pagar	8.50	6.3%
City Hall	9.82	4.0%
Orchard Road	8.91	1.7%
Beach Road/ Middle Road	7.78	7.5%

Source Savills Research & Consultancy

MARKET COMMENTARY

Since the reopening of Singapore's economy after the Circuit Breaker period, Singapore's gross domestic product has been improving. Nevertheless, in recent quarters, the global economic environment, alongside with that of Singapore, has deteriorated due to inflationary pressures, higher interest rates and ongoing geopolitical tensions. While the unemployment situation has improved in August 2022, labour market activity is now at risk of slowing down amidst signs of manufacturing activity contracting, rising inflation and further interest rate increases. On the international front, big technology firms such as Meta, Microsoft and Twitter have announced laying off staff and a freeze on hiring. Singapore-based Sea Group has been laying off staff under its e-commerce arm Shopee. A similar situation is also developing at Crypto.com.

Traditionally, main demand drivers have been financial institutions, taking up large pockets of space in CBD offices. However, many of these firms have embraced decentralisation and are moving their backend offices to decentralised locations and keeping their front office in prime CBD office space. The space that these institutions vacated were easily backfilled by technology and social media companies, many of whom signed up large quantities of space in prime CBD office buildings. However, with slowdown in the global economy and challenging capital raising conditions, curbs in hiring and even retrenchments have appeared. These firms may also attempt to reduce their office space take-up with the aim of trimming costs. This could expand the shadow space market in 2023. However, as the amount of office space these tech and social media companies signed on were relatively long term in nature, coupled with the relatively low supply of Grade A CBD space, vacancy rates are expected to remain low and range bound for the rest of this year and into much of 2023 as well.

Owing to the economic challenges affecting multinational companies and a comparatively lack of new supply, firms are turning cautious with regards to their office space requirements. Hence, when leases are due, companies are most likely to renew rather than move until business conditions improve.

DEMAND AND VACANCY

Based on the basket of CBD Grade A offices tracked by Savills, the vacancy rate contracted further for the second consecutive quarter by a larger 1.2 ppts QoQ to 5.6% in Q3/2022, as compared to the 0.4 of a ppt in Q2/2022. The declines in the vacancy rate were observed across all three gradings of offices, particularly for Grade AA buildings, which decreased by 2.4 ppts QoQ to 4.2% in the quarter. This was the lowest since Q1/2020 when vacancy rates reached 3.2%. Similarly, vacancy rates of Grade A and AAA buildings fell in Q3/2022 as well, by 0.9 of a ppt and 0.4 of a ppt QoQ to 6.5% and 6.0% respectively. While there is an improvement in the vacancy rates, shadow space was beginning to increase. The net take-up in Q3/2022 increased to 417,000 sq ft, rising from the 136,000 sq ft recorded in the previous quarter. This brought the net take-up for the first three quarters of the year to 612,000 sq ft.

The vacancy rate fell for almost all micro-markets except Beach Road/Middle Road, which increased for the third consecutive quarter by a slower 0.1 of a ppt to 7.5% in Q3/2022, compared to the 0.9 of a ppt increase in Q2/2022. Out of the other micro-markets that recorded decrease in vacancy rates, the largest declines were seen in Tanjong Pagar (-2.6 ppts) and Shenton Way (-2.5 ppts).

RENTS

With rising net demand, vacancy levels fell, leading rents to rise, albeit at a slower rate. The average monthly rents of Savills basket of CBD Grade A offices rose for the third consecutive quarter by 0.3% QoQ to S$9.50 psf, a slightly smaller rate than the 0.4% in Q2/2022. On a YoY basis, office rents were 1.4% higher, the highest yearly growth in a quarter since Q4/2019 when rents of Grade A CBD offices expanded 2.9% YoY. Across the office gradings, rents of Grade AAA offices saw rents rising 0.9% QoQ, the largest growth in a quarter since Q2/2019 when rents rose 1.0%. Rents of Grade A and AA offices also continued to grow by 0.2% and 0.1% QoQ respectively in the quarter.

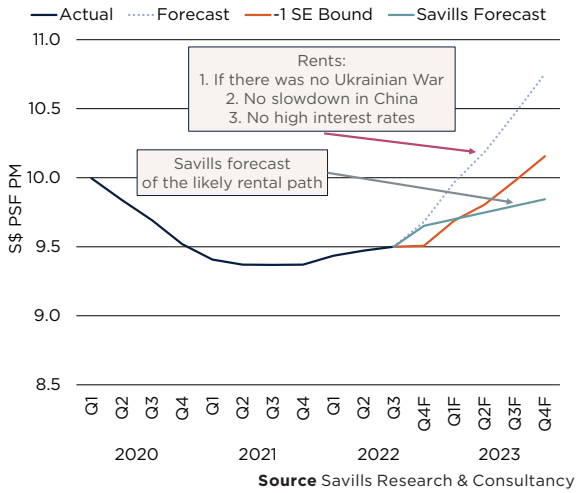
By micro-markets, rents of CBD Grade A offices in the City Hall, Tanjong Pagar and Orchard Road areas remained unchanged in the quarter, while the other micro-markets recorded QoQ increases. Out of these micro-markets that registered QoQ rental growth, monthly rents of CBD Grade A offices in Marina Bay registered the largest increase of 1.1%, the highest since Q1/2019 when rents rose 3.7%. This was followed by Beach Road/Middle Road and Raffles Place, with office rents growing 0.6% and 0.3% QoQ respectively.

OUTLOOK

In the span of a month, the chain of political, economic, and social events which resulted from the pandemic and the war in Ukraine, have weaved their influence into the fabric of the corporate world. Financial markets have started a second round of adjustments towards determined interest rate hikes by central banks to combat inflation while businesses are beginning to feel the decline in activity. The tech start-ups which raised money before the current winter are now starting to contract to conserve capital.

While the economic impact is beginning to affect office space demand in Singapore, the relocations caused by Hong Kong's battle

GRAPH 3: Overall Grade A Office Gross Rent Forecast, Q1/2020 to Q4/2023F



Source Savills Research & Consultancy

to contain the SARs-CoV-2 outbreak and ongoing political uncertainties are partially offsetting that negativity here. Together with inflation forcing up conservancy charges, landlords have been able to raise overall CBD Grade A office rents in Q3/2022 by 0.3% QoQ. The increase has been more for the Grade AAA sub-group which registered a 0.9% rise. It is in the AAA Grade space where tenants who relocated from Hong Kong to Singapore are most likely to be found.

Such tenants are often financial institutions and legal companies moving either C-suite staff, a selected few people or in some instances entire departments including Treasury, Technology and Wealth Management. This demand driver is currently supporting tenant demand whereas without it we would expect to see a net shrinkage.

Although there was much discussion since the beginning of the year over the impact of Central Banks raising rates, the notion of declining economic fortunes has only been a recent event. As late as March this year, market observers and commercial leasing professionals were still logging in a healthy level of leasing transactions, especially those in the social media and a multitude of companies leveraging off their business models on blockchain technology. Then came July and things suddenly took an about turn. A turn not for the negative, but rather enquiries from tech companies up and down the food chain were much fewer.

Our research found that had there been no war in Ukraine, no supply chain disruptions arising from that and hence no change in the interest rate regime, Grade A CBD rent in 2023 could have risen YoY by 11.1%. For 2022, the overall rental increase would have been 4%. In fact, based on a replay of how the office market performed in the last decade, rents would have started accelerating from Q3/2022 until the end of 2023. However, the confluence of geopolitical events and the asymmetric pandemic control measures in North Asia, have upset those previous relations. Increasingly, the determining factor for office demand today and in 2023 is the rising probability of economic malaise in countries which multinational tenants of Grade A CBD space hail from. Then, the rapid climbdown of global venture funding in Q3/2022 is beginning to be felt in tech sector with some tenants either ceasing expansion plans or planning to lease out excess space. Owing to the low levels of new supply in the Grade A CBD market for 2022 and much of 2023, and the tech and social media (collectively called new economy) companies that in 2021 and H1/2022 signed on large spaces, vacancies are expected to be range bound from the sub-6% to low 7% for the remainder of 2022 till late-2023. Nevertheless, the emergence of shadow space is likely as the access to new capital is forcing these new economy companies to reduce their burn rate. This is creating a sub-space market which may dominate the leasing landscape in 2023. Nevertheless, because of ESG compliance measures in their home countries, multinationals may still gravitate towards Grade A office buildings, which for all those in our basket, have some Green Mark rating. These will be the first buildings for such companies to expand or move to.

After consultation with our commercial leasing experts, we maintain our 2022 YoY rental growth forecast at 3% and extended the forecast to 2023 for a 2% YoY increase, driven mainly by inflationary pressures on the service charge element and the relatively low levels of new supply.