OFFICE

EMERGING SIGNS OF A TWO-TIER MARKET WITH GROWING RENTAL DIVERGENCE BETWEEN TOP GRADE AND OLDER OFFICES

Grade A+ office rent in the Raffles Place / Marina Bay precinct rose for the first time in nine quarters on the back of sustained 'flight-to-quality' movement while supply from looming vacancies in older buildings exerts overall check on rents.

Whilst the Singapore economy grew largely in the manufacturing sector at a faster pace in Q2 2017, the service-producing industries who are typical office occupiers added headcounts at a slower pace in H1 2017 compared to H2 2016

- According to the Ministry of Trade and Industry (MTI), Singapore's Gross Domestic Product (GDP) grew at a faster pace of 2.9% year-on-year (y-o-y) in Q2 2017, compared to 2.5% y-o-y growth in Q1 2017. This manufacturing sector (1.5%) and finance & insurance sector (0.5%) contributed the most to the GDP growth this quarter.
- The local labour market started showing some signs of stabilisation, with overall unemployment rate remaining stable at 2.2% in the first two quarters of 2017. Yet, key sectors in the service-producing industries, such as the Information & Communications sector, Finance & Insurance sector and Business Services (excluding real estate services) sector, which are typical office occupiers, have added headcounts at a slower pace during H1 2017 (5,500 headcounts) compared to H2 2016 (8,200 headcounts). For the whole of 2016, 13,000 headcounts were added on to the Information & Communications, Finance & Insurance and Business Services (excluding real estate services) sectors.
- Nonetheless, the Business Expectations Survey of Services Sector report released by Department of Statistics on 31 July 2017, showed a net weighted balance of 5.0% of firms in the services sector that envisage more favourable business conditions for H2 2017. This is a marked improvement from the net weighted balance of -14.0% for H1 2017. In particular, sectors such as Information & Communications, Financial & Insurance and Business Services (excluding real estate) are more positive about business conditions in the second half of 2017, indicating that leasing enquiries and activities across these sectors could gain traction as early as end-2017 or early 2018.
- At a global level, the economic outlook remained fairly stable in recent months, and global growth this year is expected to be higher than that in 2016. The US economy is envisaged to maintain its growth momentum into the second half of 2017, primarily supported by domestic demand on the back of resilient labour.
- On the back of improving labour market and business sentiment, economic growth in the Eurozone is likely to remain stable and is expected to pick up slightly in 2017 compared to 2016. In Asia, China's economic growth is projected to remain stable in H2 2017 following stronger-than-expected growth in H1 2017.

CALVIN YEO
Executive Director & Head, Office Advisory

"The flight-to-quality trend will continue to release opportunities over the next 2 years in choice buildings that were traditionally fully leased."

Two-tier office market emerged in the second quarter as rentals between top grade and older buildings diverged

- Average rents of Grade A+ buildings in the Raffles Place / Marina Bay precinct rose for the first time after eight consecutive quarters of decline, to register $9.34 per square foot per month (psf pm) with 0.2% quarter-on-quarter (q-o-q) increase in Q2 2017.
- Generally, leasing interest for new office developments within the Central Business District (CBD) has gained stronger momentum over the past two quarters with more tenants taking the opportunity to secure prime office spaces. Notably, tech-giant Microsoft and Ocean Network Express, a Japanese shipping joint venture comprising Kawasaki Kisen Kaisha, Mitsui OSK Lines and Nippon Yusen Yabushiki Kaisha, have committed to take up 125,000 sq ft and 50,000 sq ft of office space respectively in Q2 2017 (Exhibit 1).
- As a result of increased leasing activities, occupancy in existing Grade A+ buildings in Raffles Place / Marina Bay precinct rose from 97.0% in Q1 2017 to 97.3% in Q2 2017, the highest in six quarters. In contrast, older office buildings have yet to witness a rental recovery for Q2 2017 amid continuing headwinds. The "flight-to-quality" phenomenon with first-wave tenant moving into the newly-built Marina One East Tower and UIC Building is starting to impact older Grade A office spaces, with some landlords of these buildings under pressure to backfill their vacated spaces.
- The threat of looming Secondary spaces[1] has also added pressure on both landlords and existing tenants to hunt for new occupiers. The consolidation activities within the banking and finance sector, which has traditionally been the key occupier of office space, have released a significant total secondary space of estimated 260,000 sq ft into the market since 2017. This accounted for a substantial 70% of total available secondary space in the CBD as at end of Q2 2017.
- Consequently, average rent of older grade A buildings in the Marina Bay / Raffles Place precinct decreased by 0.2% q-o-q to $8.25 psf pm in Q2 2017, posting nine consecutive quarters of decline.

Overall prime office rents in CBD posted fairly flat trend in Q2 2017 with mixed-bag performance across precincts

- While Grade A rents in Raffles Place / Marina Bay precinct recorded declines, Grade A spaces in the Shenton Way / Robinson Road / Tanjong Pagar precinct was an outperformer, posting 0.6% q-o-q increase to $7.90 psf pm in Q2 2017, higher than 0.5% q-o-q increase in Q1 2017. The continuing revitalisation of this precinct especially since the completion of Guoco Tower has uplifted the appeal of Tanjong Pagar precinct as the next key office address for international and local enterprises.
- Average rent of Marina Centre / Suntec precinct declined by 0.8% q-o-q to $7.92 psf pm in Q2 2017. The overall occupancy in the Marina Centre / Suntec precinct also decreased to 94.3% in Q2 2017 from 94.7% in Q1 2017 due to relocation activities to other precincts and consolidation exercises by existing tenants.
- Overall rents in the CBD remained unchanged at $8.31 psf pm in Q2 2017 as rentals of Grade A buildings in most precincts posted mixed-bag performances.

Merger and acquisition activities could ensue in the co-working space segment amid stiff competition

- Co-working centres have been expanding aggressively over the past year and taking up sizeable spaces in prime locations within the CBD. Since early 2017, Singapore saw the entry of prominent foreign players, such as WeWork and UrWork cementing their footprints in Beach Road and one-north precincts.
- In total, there are 64 co-working centres operating as at Q2 2017[2], and another four centres are slated to open by H1 2018. As the competition heightens within the co-working segment, merger and acquisition activities could start to take place in H2 2017.

[1] Based on Knight Frank definition, secondary space refers to current occupied space that is available for lease form the existing tenant.

[2] According to data compiled by Knight Frank Research

Market Outlook

- In the coming quarters, the global economic outlook is expected to improve and business expectations likely to turn positive. For the full year of 2017, MTI expects trade-related sectors such as the finance & insurance and transportation & storage to provide support to the Singapore economy. The information & communications, education, and health & social services sectors are expected to remain resilient albeit with potential moderate growth. The enquiries and activities across these sectors are expected to sustain or gain traction as early as end-2017 or early 2018.
- Despite a pick-up in leasing activity in H1 2017 compared to 2016, the net take-up of office space is projected to be only moderately higher from 2016, with leasing demand likely to originate from technology firms, consultancy groups, co-working centres and other diverse types of service trades. Set against the anticipated new supply of about 3.1 million sq ft NLA of office space, island-wide occupancy rate is likely to decline to between 86% and 87% by end-2017 from 88.9% in Q4 2016.
- Relocation activity from small and medium-sized tenants is envisaged to gather momentum in H2 2017, as they will have more viable choices to upgrade their offices to value-for-money secondary spaces at prime locations in the CBD.
- Envisaging an improvement in space take-up on the back of firmer economic growth and coupled with limited new supply in the Raffles Place / Marina Bay precinct in the next three years, prime office rents in this core CBD precinct will likely recover by 1% to 2% y-o-y by end-2017. Rents in other precincts are poised to stabilise in the second half of 2017 maintaining a flat to marginal upside of 1% to 2% y-o-y by end-2017.

EXHIBIT 1

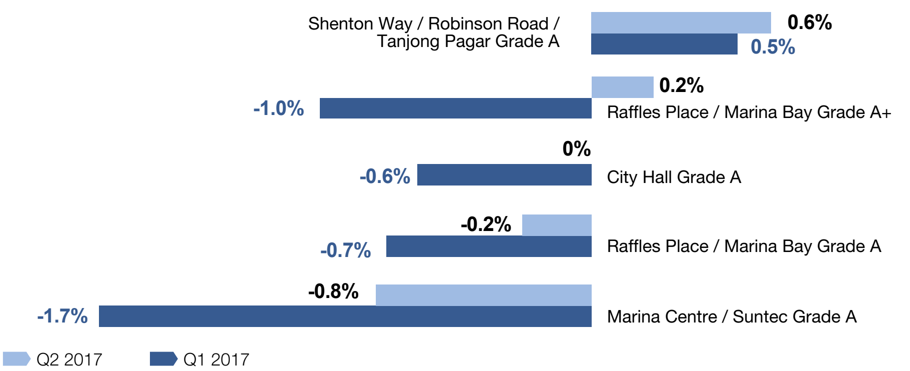
Shifts and expansions of selected enterprises in Q2 2017

Tenant	Sector	New Location	New Size (sf)
Microsoft	Technology	Frasers Tower	125,000
Ocean Network Express	Shipping	Marina One	50,000
Ecolab	Chemical	JEM	27,000
Sumitomo Chemical	Chemical	DUO Tower	25,000
Mott Macdonald	Consultancy	The Gateway	24,000

Source: Knight Frank Research

EXHIBIT 2

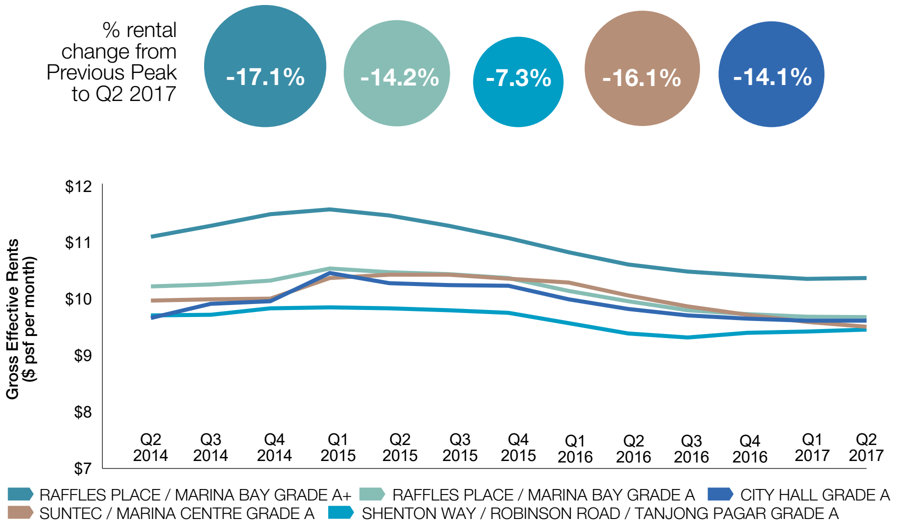
Quarterly Percentage Change in Average Office Rents, by Key Precincts within CBD for past two quarters



Source: Knight Frank Research

EXHIBIT 3

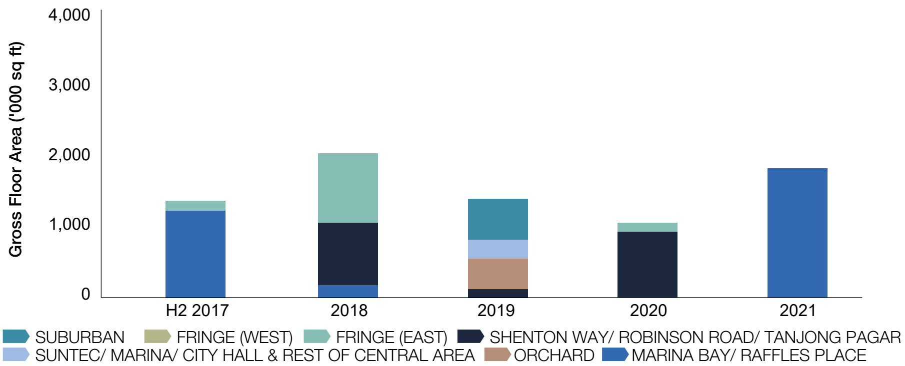
Average Office Rents, by Key Precincts within CBD



Source: Knight Frank Research

EXHIBIT 4

Upcoming Office Supply (Gross Floor Area), as at June 2017



Source: URA, Knight Frank Research

EXHIBIT 5

Average Office Rentals, by Key Precincts in Q2 2017

Location	Gross Effective Monthly Rentals (S$ per sq ft)	Q-on-Q Change (%) Q2 2017	Y-on-Y Change (%) Q2 2017
CBD (Grade A+, Grade A)			
Raffles Place / Marina Bay Grade A+	$9.10 - $9.60	0.2%	-3.9%
Raffles Place / Marina Bay Grade A	$8.00 - $8.50	-0.2%	-5.2%
Shenton Way / Robinson Road / Tanjong Pagar Grade A	$7.70 - $8.20	0.6%	1.3%
Marina Centre / Suntec Grade A	$7.70 - $8.20	-0.8%	-7.4%
City Hall Grade A	$7.90 - $8.40	0.0%	-3.9%
Central Area (Outside CBD)			
Orchard Grade A	$7.80 - $8.30	0.1%	-3.3%
Others			
Fringe Areas	$4.70 - $6.70	-0.2%	-5.0%
Suburban Areas	$4.20 - $5.20	0.0%	-3.2%

Source: Knight Frank Research

(1) Rents are based on transacted leases
(2) Rents are based on a lease term of at least three years
(3) Rents are expressed as values rounded to nearest 10 cent
(4) Rents are estimated based on leases of a whole-floor office space on the mid-floor levels of office properties, and taking into account rent free period and other concessions

For further information about the company, please visit **www.knightfrank.com.sg**

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