Hong Kong: Uncharted Territory
Mapping out the Future for Hong Kong Landlords
Offices 2020 City Report
Offices 2020 Asia Pacific, preparing for changing trends today

Forming part of a suite of Office 2020 reports on six Asian cities, the Report you are holding will seek to answer ‘where next for Hong Kong?’

Themed around six specific questions, we discussed with key industry leaders in each city how the big picture will shape the offices landscape to 2020.

This report is not about predictions – it is about building the best possible assumptions about the future and identifying a variety of opportunities based on these conversations.

Our aim is to help you start the conversation now, support your decision making today, and enable your business to outperform in the future.

We believe our Offices 2020 initiative is: ‘foresight with a purpose’. The philosophy behind our investment in thought leadership is captured nicely by the old Chinese proverb:

Those who do not worry about the future will soon have worries about the present

Join the conversation and add your views by visiting www.jll.com/offices2020ap
Hong Kong – Are You Ready for the Future?

In the last 15 years, a total of 27 million sq ft of office space has been built in Hong Kong, representing 30% of the current total. According to the government’s plan for Kowloon East, the potential exists for a further 28 million sq ft of office space to be added in this submarket alone. Landlords in Hong Kong have enjoyed a long period of limited supply and low vacancy.

But have they grown complacent? Is the current state of tenant relationship management antiquated against the standards seen in other developed markets? Will a significant increase in supply in emerging submarkets around the territory bring a new set of owners and landlords into the market? Could this competition change the current dynamics between landlords and tenants? How is your portfolio positioned to deal with this potential threat?

New supply will bring many opportunities for tenants:

- Consolidating in lower cost space
- Occupying new higher-specification buildings
- Densifying in highly productive work-spaces
- Potentially owning their office premises
- Meeting their green objectives and lowering resource consumption

The investment in infrastructure being made this decade, together with the changing demands of emerging groups of tenants, could be enough of a catalyst for one of the new development nodes in Hong Kong to achieve the critical mass needed to truly compete with Central.

Starting the conversation:

At the end of each section of this series of city reports, we have interspersed some thought-provoking questions to inspire further consideration on the implications for your business. In order to be positioned for the future, have you thought about these issues:

- What are the implications of corporates from Mainland China becoming a more important source of demand for office space in Hong Kong?
- In a future Hong Kong which is multi-nodal, would Central be more or less important than it is today?
- What could create the momentum for Kowloon East to become a viable front office location?
- Are you safeguarding your portfolio against future competition?
- How are you taking advantage of the development opportunities in new areas?
Focus for Occupancy and Growth

Hong Kong has long served as the major gateway for foreign companies seeking to do business with China. However, as we move forward, a new dynamic is set to come into play with the emergence of Chinese MNCs.

Hong Kong’s strength as an international centre for finance and commerce offers an ideal platform for Chinese companies to make a foray into global markets. It has strong cultural ties with the Mainland and a reputation as an established business centre that offers stable and trusted rule of law, regulatory certainty and a peg to the US dollar. It also offers low corporate and personal income tax, unrestricted movement of capital and sophisticated financial markets. This gives it a distinct advantage over other international centres such as Shanghai, New York and London. Moreover, many of these strengths are highly durable, which will be increasingly important once the Renminbi becomes convertible and other Mainland Chinese cities – including upstarts within the Pearl River Delta such as Qianhai, Hengqin and Nansha – improve their competitiveness.

Figure 1. Foreign companies with offices in Hong Kong

Source: Census & Statistics Department
These competitive advantages cannot be taken for granted. Today Hong Kong has the highest office rents in the world. Given the extremely low vacancy rates in the market, any up-tick in demand translates quickly into further pricing power for landlords. However, the high cost of occupancy could ultimately weaken the overall competitiveness of the city as a business location. In this regard, the government must adopt the correct policies to ensure that land supply is able to meet market demand and accelerate the development of office markets outside Central, providing occupiers with a greater array of options.

A key consideration is where demand is most likely to grow in the coming years. Finance will remain a key driver of employment growth, but its effect will be limited. It is unlikely that any bounce back among western financial services companies will lead to employment growth as strong as has occurred in the past. Banks and other financial institutions have changed, and their new, more efficient business models now need fewer staff to operate. On the other hand, demand for staff by Mainland Chinese banks will be robust. There is a waiting list estimated to be made up of a dozen Chinese banks looking to open an ‘overseas’ office in Hong Kong – and second tier banks will continue to follow over the decade. Hong Kong’s future prospects will increasingly be tied to decision-making in China.

Although the number of Chinese companies with offices in the city has more than tripled over the last 10 years – helped along by China’s accession to the WTO in 2001 – currently, less than 1 in 8 foreign companies with offices in Hong Kong are Mainland Chinese companies (Figure 1). The relatively low presence of Chinese companies in the city suggests that the demand for office space over the coming years will be immense.

In addition, the technology and retail sectors are also expected to grow strongly. The use of office space among these industries is not as closely tied to prime locations. Other professional services – consulting, legal, accounting – will fluctuate naturally according to the business cycle, but each will act as net contributors to overall employment growth, especially mainland companies who will be following their clients to Hong Kong.

All this will translate to a rising demand for office space through 2020.

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<td>A governmental mind shift away from laissez-faire</td>
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What does this mean for landlords?

- Do you understand the requirements of corporates from Mainland China?
- Will corporates from Mainland China be the payers of the highest rent in Hong Kong in the future?
Hong Kong’s Central district is one of the world’s most renowned CBDs. Landmark office buildings are complemented by first class hotels, luxury retailing, excellent public transport and interconnecting walkways. Does this mean that Central is the perfect definition of a successful office location?

The answer to this is, from a tenant perspective: not necessarily. This is especially the case when you consider that Central contains some of the most expensive office real estate in the world. In addition, many of the buildings are not up to modern specification, such as the provision of power, while vacancy rates are so low that expansion and consolidation is extremely difficult. These factors – cost, specifications and availability – are causing many decision-makers to consider alternatives.

There are a number of new locations evolving in Hong Kong and these will become substantive poles of attraction over the next 7 years. We have highlighted the top four locations that we believe have the potential to emerge as core office locations for all industry segments, including banking and finance.

Our 2012 paper Broader Hong Kong – Commercial Space Master-plan Embraces CBD2 Development indicated that the office market outside Central is developing eastwards. Although Kowloon East has been earmarked by the government as a key office location for the future, the market will first develop along the north side of Hong Kong Island before making the eventual jump across the harbour.

Hong Kong East
At present, a number of professional and business service firms already call Hong Kong East home, and at least one bank has relocated its trading floors into the area. While it will take time for Hong Kong East to make the full transition, there are two key elements in its favour. Firstly, mixed-use precincts, which include offices, retail outlets, hotels and serviced apartments, generally attract the eye of corporate occupiers. This is clearly evident in Hong Kong East. Secondly, the completion of the Central-Wanchai Bypass and Island East Corridor Link, earmarked for 2018, will further enhance the accessibility between Hong Kong East, Central and other major commercial districts.
Offices 2020
Hong Kong

Starting the conversation:

■ In a future, multi-nodal Hong Kong, would Central be more or less important than today?
■ What could create the momentum for Kowloon East to become a viable front office location?
■ Will the private sector drive future development?

Kowloon East

Kowloon East, in a very real sense, is the government’s favourite for success, and it is doing everything it can to achieve that ambition. In recent years, the government has introduced policy measures that promote the redevelopment of older industrial buildings and facilitate land supply. It has also invested heavily in a substantial MTR infrastructure initiative, and will open government offices in Kowloon East. In response, developers are building Grade A offices in anticipation of tempting companies out of the city’s traditional office locations with rental levels which are comparatively low cost.

Kowloon East will, however, take time to transform into a successful office location. The public transport infrastructure will not be fully completed until after 2018, and until recently, vacancy rates were hovering as high as 20%. Meanwhile, as there is so much land to be redeveloped, individual developments face the risk of isolation. At the outset it will take time to link everything up. Finally, the opening of amenities including restaurants and shops will only occur gradually and follow office development. Ultimately, the government can only do so much and must rely on the market to respond.

While the sheer scale of development means that the full potential of Kowloon East may not be realised by 2020, this area should be expected to eventually emerge as a mid-office location housing operational staff of large companies as well as the front offices of companies outside the finance industry.

Wanchai and Causeway Bay

Although the evolution of the office market outside Central will initially materialise in Hong Kong East, the completion of a new transport infrastructure – including the new Exhibition MTR station on the future Shatin-Central Rail Link – as well as the release of developable land, will see the focus of market development doubling back towards Wanchai and Causeway Bay. Ultimately, the lack of developable land in Hong Kong will likely result in Wanchai and Causeway Bay morphing into a primary office location for professional service providers serving clients in Central and Hong Kong East.

West Kowloon

If Kowloon East receives most of the media attention, West Kowloon has staked its own claim through the towering ICC building. A true mixed-use scheme, the next few years will see infill around this pivot. The arrival of the high-speed rail link between China and the heart of this district will spur further office interest. Although the ingredients are in place for West Kowloon to evolve into another front office location, the most recent plans suggest the area will be developed primarily as a retail and leisure hub, rather than a purely office location. As such, owing to constraints on supply, West Kowloon is likely to remain as an isolated office node that is unlikely to achieve a critical mass, unless the government can be persuaded to change their development plans for the area.

It is for these reasons that we anticipate change in multiple locations over the next seven years, and a redrawn map for Hong Kong’s tenants.
Winning the Relocation Decision
The factors that seal the deal

For an office location outside Central to become a competitive commercial district it must be able to attract a critical mass of large tenants. It does not necessarily have to tick every box, but it must offer enough ‘pull’ factors to be compelling. The most obvious elements are a real “sense of place” in terms of community, with a wide variety of amenities. The other key element is accessibility through convenient public transport and connectivity. These are things that Central obviously has in spades. But there are also other ways in which real estate can play an important role in making a competitive offering to draw tenants to alternative locations. Landlords who are able to put some of these options on the table could really change the game.

What might ‘pull’ tenants away?

- New higher-specification buildings
- Strong regional transport links
- Lower cost of occupation
- Ownership opportunity

Infrastructure should be considered first. Improvements to public transport infrastructure and road networks are shrinking the geography of Hong Kong, making the idea of relocation outside Central increasingly easy to consider. We have already discussed the long-term significance of the MTR investments for Kowloon East and Wanchai and Causeway Bay, as well as the importance of the Central-Wanchai Bypass for Hong Kong East, but there are other large scale projects that will affect how Hong Kong connects with the rest of the region. Some trading businesses will find that the zone to the airport is increasingly attractive, especially with the completion of the Hong Kong-Zhuhai-Macau Bridge. Chinese companies and those with a strong Chinese customer or supplier base may prefer to be close to rail connections that can rapidly transport them into China.
The development and emergence of Kowloon East over the next decade has the potential to shake things up in the property market. Unlike the city’s other established office nodes, currently there is no single dominant landlord in the district. This, together with an abundance of land supply, could prove to be an opportunity for a new office market to emerge with a diverse ownership structure. Healthy competition will be a boon for occupiers as landlords seek new means to differentiate themselves from the pack.
Starting the conversation:

- Are you safeguarding your portfolio against future competition?
- Short of redevelopment, what are some of the soft measures you can adopt to remain competitive against larger, more modern office buildings outside Central?
- How are you taking advantage of the development opportunities in new areas?
- What form would more creative partnerships with your anchor tenants take?
Planning for the Future… Today

Will new technology and management theories have an impact on office architecture/space?

There are a number of global trends that are emerging in the world of corporate real estate that could impact how offices are configured and influence the design specifications of new buildings. Hong Kong is one of the densest markets in the world and the pressure on space in the city has several implications for how people work:

- Small plots for offices generate towers with small floor plates, meaning that offices will not benefit from the scale effects of hot desking in the same way as larger buildings can.
- When it comes to Hong Kong locals, it has been said that ‘densification is easy, but sharing is difficult’. Dense spaces are not necessarily harmonious spaces and there is a limit to how far office managers can press people together. Nonetheless, dense desk allocation is not a management fashion, but a long-term reality.
- Small residential spaces, often housing an extended family, mean that working from home is not a viable alternative in Hong Kong, so this will not become a dominant theme.
- Finally, in Hong Kong, workers prefer to work in offices.
Looking at technological impacts into the future, Cloud computing could mean fewer servers and less strain on office services. However, don’t expect to see data servers disappear overnight. American companies are now under much greater pressure to back-up their data, so many will have mirror systems – this means they may keep their own servers on site, and duplicate in the Cloud. In addition, the arms race in technology on the trading floor continues, and power requirements are climbing, making it increasingly difficult for banks to remain in traditional buildings.

Going forward, less cabling will see new builds with lower raised floors, and the practical reality of wireless power is now coming to the fore. Many older Hong Kong buildings did not initially have raised floors, and this could lead to a rising trend whereby they undergo quality refurbishment to house new types of tenants.

With all of that said, if alternative locations can offer abundant modern, high-specification buildings with larger floor plates – at lower rents – many more tenants would move into these less dense and higher productivity spaces. And if relocating allows them to expand or consolidate at the same time, which may not be possible in Central, all the more reason to take advantage of such an opportunity.

Starting the conversation:

- Are landlords in high-rent locations prepared to support ever higher levels of density in order to stay competitive – providing more modern lifts, chilled water supply for data servers, increased power loading and back-up generators and higher grade network cabling?
- Are you looking at technology issues to make your portfolio more competitive?
Can Flexible Tenure ‘Make Places’ Faster?
Market evolution could shift the balance

As a rule of thumb, in tomorrow’s world, tenure in the Hong Kong market will seem like a sandwich. At the top end, the very biggest corporates and Mainland Chinese SOEs will seek to own offices. Meanwhile, at the bottom, the smallest firms will purchase floors, even single offices, in strata buildings. The rental market will be positioned between the two.

This pattern is new. Formerly the larger corporations would also have leased space, but something is changing:

- Chinese entrants prefer owner-occupancy.
- Big corporates and Western banks are now looking longer term. Hong Kong is seen as being strategic but volatile – so owning is attractive. Companies are also anticipating inflation down the line, so real assets are a key hedging strategy. Another factor is that companies are wary of how much management time is lost when they review their lease every three or so years. Purchasing a building is a bigger decision but, once it has been made, the next decade at least is sorted.
- With the new lease accounting regulations expected to come into full effect in 2017, the criteria for deciding whether to lease or buy will fundamentally change, and corporates will have to adjust their corporate real estate strategies accordingly. Under the new regulations, it will no longer be possible to manage the balance sheet through operating leases.

- Branding is becoming increasingly important across the globe. Iconic buildings in iconic cities are important signature statements for the largest enterprises. Companies are seeking offices as ‘brand showcases’.
- Capital is abundant and cheap. So, whilst many management teams would be criticised by shareholders if they were unable to produce better returns from their core businesses, some businesses generate so much cash that capital needs to find a home somewhere. Chinese SOEs and even Hong Kong industrialists find themselves in this position.

The issue in Hong Kong concerning this particular trend is not that it is occurring, but that companies find very few options to satisfy their ambitions to buy.

Companies are saying: ‘We believe in Hong Kong, and if only we could find a suitable building, we would make a purchase’. The fascinating question, then, is how much patience do these frustrated purchasers have? With limited opportunities to buy in the CBD, some companies will look elsewhere. Given the land supply in Kowloon East, could ownership be the catalyst to attract enough large occupiers and help it achieve critical mass?
Starting the conversation:

- Should you consider allowing anchor tenants to co-invest as part of a broader portfolio management strategy?
- How does the presence of large SOE buyers affect the long-term valuation of investment properties?
- Should you consider selling non-core assets to re-deploy capital in evolving office locations such as Kowloon East?
Sustainability - Is the Green Era Finally Here?

Will the city’s green agenda trigger a drive for efficiencies among landlords and tenants?

New builds tend to be sustainable but the majority of existing office stock is not. Regardless of the starting point for the debate about sustainable buildings and its impact on lifecycles, the forecast for the next seven years is that the breadth and depth of the green agenda will grow.

There are several arguments which support this thinking:

- The government headquarters is an extremely green building. Legislation around air quality, thermal transfer, construction waste (a major problem in Hong Kong) and life-of-building accreditation will continue to become increasingly stringent.
- More data is being collected on the benefits of energy saving; over time, the return on investment on greener buildings will be clearer.
- Owner-occupiers are insisting on greener features for properties they wish to purchase. Investors, with more skin in the game, wish to future-proof. This market lead will be followed.
- Progressive developers have appointed a ‘Technical Sustainability Services Department’ for all developments.

While all of the above points may add weight to the argument to go green, perhaps the simplest and most effective would simply be for landlords to pass on any savings to occupiers. Property management in Hong Kong has traditionally been operated on a closed book basis, and is a profitable business for many landlords. At present, there is little incentive for landlords to pass on any savings to occupiers. However, with competition for occupiers increasing from the emergence of Kowloon East and other future office ‘hotspots’, passing on savings to occupiers could become a key differentiator for landlords in their race to secure high quality tenants.

All told, this does not sound like ‘greenwashing’ but a strong and genuine movement towards a growing sustainability agenda. Over time, it is likely that contrarian views will be seen to be misguided and eventually drowned out as others get on with sustainable agendas.

Hong Kong players are starting to realise that green buildings are better buildings and more lettable offices. Over the next few years this realisation will become a conviction.

Starting the conversation:

- Who will be the first to pursue ‘creative destruction’ and offer property management on an open book basis?
- If tenants see a financial benefit as well as a CSR benefit, can sustainability be both a marketing differentiator for landlords and a means of driving higher rents?
“All told, this does not sound like ‘greenwashing’ but a strong and genuine movement towards a growing sustainability agenda. Over time, it is likely that contrarian views will be seen to be misguided and eventually drowned out as others get on with sustainable agendas.”
Have you Got the Answers?

Hong Kong landlords have enjoyed an exceptional run over the past 15 years, complemented by years of very limited supply and low vacancies. Although there have been some ups and downs over this period, supply has rarely been a contributing factor to any sustained market downturn. In essence, it has very much been a landlords’ market.

However, with government policies promoting land supply and new public transport infrastructure set to accelerate the development of new office nodes outside Central, this dynamic could finally be coming to an end. For the first time in a long time, occupiers will have the upper hand in certain negotiations. The changes in the physical landscape of the office market will be further compounded by changes in tenant demand brought about by the growing dominance of Chinese companies, new technology and the realisation of the green building movement.

Moreover, as China grows and dominates the region, some boards will inevitably consider the option of entering China directly rather than using Hong Kong as an entry point, a trend which can already be seen among manufacturers and pharmaceutical companies. Others might question why they would relocate their back-office functions to Kowloon East, for example, when India and the Philippines wages and rents are far lower. These conversations will continue to come up in the future.

Simply put, the way real estate decisions were made in the past are unlikely to resonate in the future. Both landlords and occupiers will need to reassess their real estate strategies to succeed in an increasingly competitive landscape.

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<td>- Increasing competition from Mainland cities</td>
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<td>- Narrow industry base</td>
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<td>- Rising occupancy costs</td>
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<td>- Growth of Chinese corporates</td>
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<td>- Completion of new public transport infrastructure</td>
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Methodology

The methodology behind these reports is based on a Grounded Theory approach developed by Barney Glaser and Anselm Strauss. Grounded theory method does not aim for a single end truth, rather it is an evolutionary process to conceptualize into a useful format what is happening by using empirical research from a variety of data sources. In essence, you examine the data and ask what is happening, rather than form hypothesis that you then try to disprove.

In this case, the empirical research consisted of several steps culminating in a series of workshops with clients across six cities. First was examination of our existing Jones Lang LaSalle research on the office markets to devise concepts areas or for further research. These areas were then discussed and refined into eight areas through discussion with Asia Pacific research heads from some of the largest investment funds into offices. The research heads were extremely keen to understand what occupiers want and how the leasing process can provide a long term relationship for both parties.

The eight questions were then posed to clients. In each of the six cities, we invited three corporate occupiers clients and three clients representing the development process and the landlord community to a workshop round table discussion. These clients were joined by our Jones Lang LaSalle colleagues in each city, representing a wide variety of functions and included heads of leasing, transaction management, capital markets, property management, work place strategy, facilities management and other senior management. The 12 participants in each city spent several hours debating the questions and presenting their alternative views.

This written report is a step along the way in the process of discovering a shared view of the future of offices by clients and ourselves in six very different cities in Asia Pacific.