

Real Estate Outlook

Hong Kong – Edition 2020



Catch-22



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Stability the biggest known
unknown.



Political risk (amid rising social tensions) has never been more apparent until the unprecedented anti-government protests in 2019. For Hong Kong's economy, links to mainland China will be the most important catalyst for ongoing prosperity, but the key mid-term consideration for real estate market participants will be stability.

Hong Kong



Signposts

- Chief Executive election 2022
- Greater Bay Area interim milestone 2022
- Lantau Tomorrow Vision reclamation 2025



Threats

- Real estate's over-dependence on China
- Change in investor attitudes towards HK
- The emergence of Shenzhen



Opportunities

- Office decentralization theme continues
- Selective opportunities in Industrial
- Non-discretionary retail has resilient traits

Stability called into question

To put things into perspective, Hong Kong's economy shrank by 1.2% in 2019, the first contraction in 10 years. In 2009, Hong Kong was badly affected by the fallout from the GFC, and that was a financial event which many countries were not spared from. The situation now is slightly different.

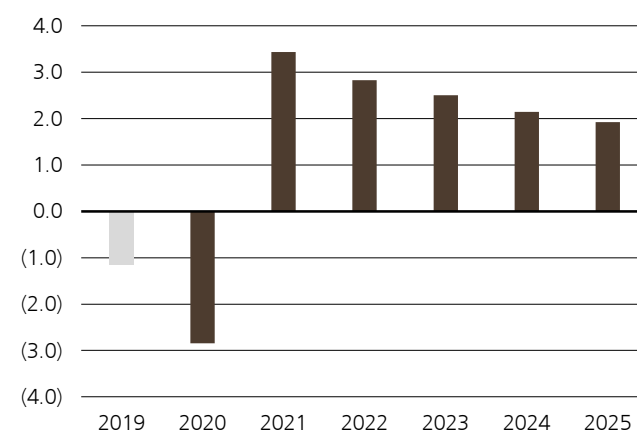
On the external front, the trade tensions in 2019 between China and the US put Hong Kong between a rock and a hard place. The long-term outlook is shaped by developments in China, but it is fully exposed to the shifts in global financial and trade issue which remains rickety still. Yet, domestic problems were what really dragged down overall economic performance in 2019, as anti-government protests intensified towards the second half of the year, weighing on tourism and consumption.

As they say, it never rains but it pours. As Hong Kong residents struggled to come to terms with daily life being disrupted by frequent mass protests and violence, the COVID-19 outbreak occurred. Market observers have commented that the onset of the virus coincided with a winding down of the protest movement, likely as concerns over the contagion made many stay off the streets. Overnight, face masks that once symbolized the dogged determination of the protest movement now represent unity, health and safety for the city.

Then again, it could well be a Trojan horse, because the negative effects of the pandemic, if uncontained, may deliver a fatal blow to the already fragile economy. Moreover, there is no guarantee that the domestic unrest has been resolved, as political groundswell may stir to life again.

Figure 1: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
Note: Data for the period 2020-2025 are forecasts.

Hong Kong remains joined at the hips with China. Economic linkages with mainland China will be the most important catalyst for ongoing prosperity in Hong Kong, but we also note that heightened political risks from rising social tensions are increasingly a key point of concern for investors. It is apparent that politics will affect the real estate market in Hong Kong more than anything else. From sentiments to capital flows, right up to underlying property demand, the mid term consideration for real estate market participants is stability.

And that stability, or the certainty of Hong Kong's position in the regional and global hegemony, is what will make or break the real estate markets in the next half decade. That said, Hong Kong's economic fundamentals remain sound on account of a well-regulated financial and banking sector, strong fiscal position and a tight labor market that will support wage gains. And these are unlikely to change drastically in the next five years.

Signposts we are watching out for

There are a few milestones that are meaningful from now till 2025, and could have immediate and longer-term repercussions on Hong Kong and its real estate sector. We encourage investors to watch the local political situation closely. The 2019 Hong Kong district council elections saw the 'pro-democracy' camp score a resounding victory over the 'pro-establishment' group. The significance is not so much a change in governance or laws as district councilors have no direct governing powers, but rather an endorsement of the sentiments at the grassroots level.

The Legislative Council election is due to take place by September 2020, with up to half the seats determined by popular vote. What we are watching, is how the outcomes of these elections may influence China's stance towards Hong Kong. Further down the line, the next Chief Executive election in 2022 will throw light on whether moderation and conciliation can occur, or whether persistent public anger and confrontation are here to stay. The next five years are critical to investors, particularly long term asset owners, as political developments now have a more than outsized impact on real estate values and performance in Hong Kong.

The Greater Bay Area (GBA) is a strategic regional cluster consisting of nine cities in the Pearl River Delta and the two special administrative regions of Macau and Hong Kong. In a blueprint released by the Chinese government in early 2019, the next milestone for the GBA will be in 2022, by which time there should be a vibrant cluster facilitated by infrastructure and the seamless exchange of people and services. The GBA blueprint highlighted Hong Kong's importance as the region's financial center, international financing hub and offshore RMB center. Real estate investors will be monitoring this development closely, as any diminishment of Hong Kong's role in the GBA master plan within the next five years could adversely influence its global positioning in the long run, affecting the commercial real estate market.

Between 2014 and 2016, the Hong Kong government conducted a deep-dive into the city's development strategy, which culminated in a report (Hong Kong 2030+). Notably, the findings concluded, amongst others, that Hong Kong is facing a land deficit, which has been reflected in soaring residential and commercial property prices. In late 2018, the government announced a long-term plan (Lantau Tomorrow Vision) to reclaim more than 1,700 hectares of land along East Lantau. Preliminary projections have factored in the provision of approximately 43 million square feet of commercial floor space.

Also, the reclaimed land will be able to accommodate close to a million people in about 400,000 residential units. Does Hong Kong need another third CBD after Central and Kowloon East? While slated to be underway only from 2025, with fiscal affordability being a real concern for now, investors should be monitoring the key developments for this project, as that could alleviate housing (and social) woes and improve the affordability problems faced by many commercial tenants.

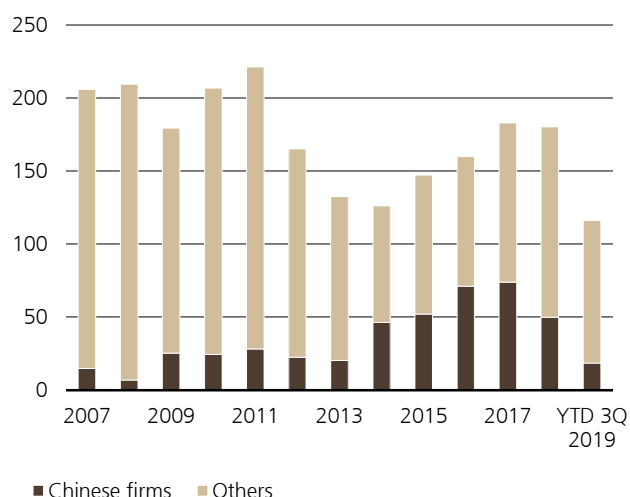
Imminent threats

The medium term risks that we have identified in Hong Kong pertain to political and social issues, and much of the looming threats derive directly from China's actions.

The Hong Kong commercial real estate's dependence on mainland China is a double-edged sword which is hard to unweave. The relevance of Hong Kong as an international office market has been increasingly thrust into the limelight, as the occupier profile of the office sector shifted from a clear dominance by multinational firms towards a market driven by growing demand from Chinese mainland occupiers. This growth in demand from mainland China firms, particularly from the finance sector – which accounts for over a third of all reported CBD demand in the past three years – has played a key role in pushing up prime office rents in Central. In the past year, anecdotal feedback suggests that many corporates have ceased their expansion plans and lease renewals have generally taken a backseat.

Enquiries from Chinese companies have largely evaporated, and that is significant for office absorption in Central given the reliance on this tenant group in the last few years. In the retail sector, in the last months of 2019, headlines were focused on Hong Kong, in particular the plunge in retail sales due to a sharp drop in tourist numbers. China's "Golden Week" holiday in October did not translate into a tourism bonanza for Hong Kong, as mainland Chinese tourists diverted their holidays elsewhere. Compared to the same month in 2018, visitor arrivals in October 2019 plunged by more than 40%. Periodic episodes of social unrest have also dampened the festive mood, keeping many local shoppers off the streets in 2019.

Figure 2: Hong Kong CBD office take up
(million sqm)



Source: PMA (as at October 2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

From capital might to capital flight, changes in investor attitudes could trigger a sustained dull in the real estate sector and liquidity. Hong Kong saw the biggest absolute and YoY decline in investment volumes in 2019. From a high of more than USD 25 billion in 2018, commercial investment volumes fell to around USD 13.8 billion in 2019, a significant 45% fall YoY. The last quarter of 2019 also marked the lowest quarterly investment volumes since 2009. This can hardly be described as surprising, given the upheaval experienced in the second half of 2019.

We do not expect any major knee jerk reaction by owners in the form of distressed sales, nor do we believe that cap rates will decompress significantly in the next three to five years. However, if the political environment worsens after the COVID-19 outbreak eases off, there could be a medium term downside exposure to capital outflows, which may ultimately affect property valuations. This would be felt in all sectors, from the luxury residential markets to the office sector, bearing in mind the offshore asset allocation by mainland Chinese investors.

Shenzhen is the closest competitor that can challenge Hong Kong's position in the region. And there is a real and emerging chance that the Chinese government will frame the political crisis, if unresolved, as the catalyst to speed up the development of Shenzhen in the next five years. Already, the GBA plan puts forward Shenzhen as the key hub for innovation and technology, and it is no exaggeration to say that Shenzhen is the leading city in China in this area. Shenzhen's GDP overtook Hong Kong in 2018, partly because of its booming high-tech industry.

With a bustling stock exchange and growing ecosystem of growing companies, and if Beijing diverts more resources towards the targeted development of Shenzhen, it could well dilute Hong Kong's appeal to multinationals and Chinese companies. Obviously, Hong Kong has had a massive headstart, and its legal and business frameworks render it more conducive to investors. For now, we are putting forward this risk as one that is unlikely to materialize overnight but could very well be a reality in the longer term.

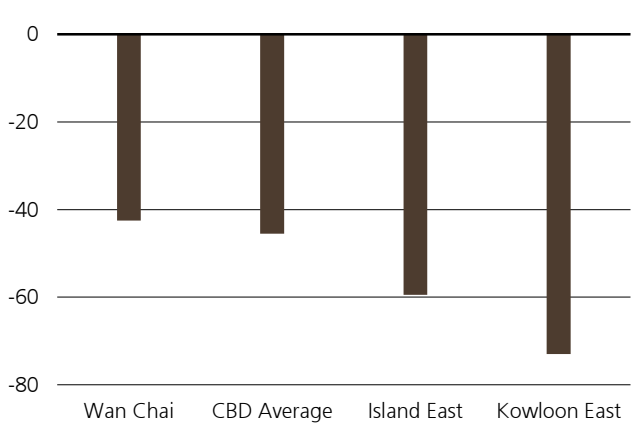
Opportunities in the next five years

We emphasize that Hong Kong's venerable position in the global real estate market has been built up over many decades. Amidst the long term challenges, there are still ample opportunities that real estate investors should pay heed to.

The decentralization theme and the growth of the second CBD in Kowloon East continues to play out in Hong Kong. We continue to be believers in the long-term viability of office decentralization in Hong Kong, whether it is occupiers making a lateral shift from the prime Central area to the less congested sub-markets of Causeway Bay and Island East (especially with infrastructure improvements such as the opening of the Central-Wan Chai Bypass) or occupiers moving off Hong Kong Island altogether into Kowloon.

With vacancy rates extremely tight in Central, that theme should continue to gather pace in the next few years, despite the expected weakening of occupier demand. A lack of supply in the Central area continues to underpin our thesis that, in the absence of any full-fledged and adverse response by China, prime office market values and rents will continue to hold up in the near term after the impact of the COVID-19 outbreak is accounted for. Looking beyond 2025, investors should have a clearer view if the decentralization story will play out even in the Lantau region. For now, affordability concerns will continue to drive occupiers towards Kowloon East.

Figure 3: Rent gap to Central submarket (%)



Source: PMA (as at October 2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

The sequel to the 2009 industrial revitalization plan was announced by the government in late 2018. The renewed scheme allows for extra floor area in the conversion of entire industrial buildings built before 1987 into commercial purposes. The government ropes in the private sector in the renewal of old districts and aging industrial buildings, while allowing investors to take advantage of lower costs compared to acquiring new land.

Obviously asset enhancement on existing industrial assets is not without challenges. The limitations on power loading and mechanical structures often mean that there may be additional costs related to such conversions, which may tilt the economics the other way.

All said, this is a window of opportunity for many asset owners and investors to identify areas where the greatest upside in conversion value may manifest. Also, approximately six million sq ft of logistics space could be removed from the Hong Kong market over the next five years which is expected to exacerbate an already tight warehouse market. Healthy demand from 3PL companies supported leasing activity, driving overall warehouse vacancy rates to a four-year low.

Low vacancy is underpinning the defensive qualities of dominant shopping centers. While we have concerns over Hong Kong's dependence on China and tourism in the prime retail segment, we are optimistic on the long-term performance of suburban retail. The dense urban layout of Hong Kong means that retail offerings are mostly a stone's throw away from most residential areas. One will almost never need to travel more than 15 minutes in order to dine at a proper restaurant or to, for instance, purchase some basic groceries.

In a country where living space is limited, retail takes on the role of the "third place", after the home and the workplace. What this means is that the need for disruption on physical retail by e-commerce is less flagrant in Hong Kong. Investors can focus on non-discretionary retail, such as suburban malls which are supported by wide residential catchments and non-discretionary domestic spending. Execution-focused investors will be able to tap on pockets of opportunities in Hong Kong in the value enhancement of poorly managed suburban malls, of which the intrinsic value was never truly unlocked.

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