Hong Kong - February 2020

SPOTLIGHT
Savills Research

COVID-19

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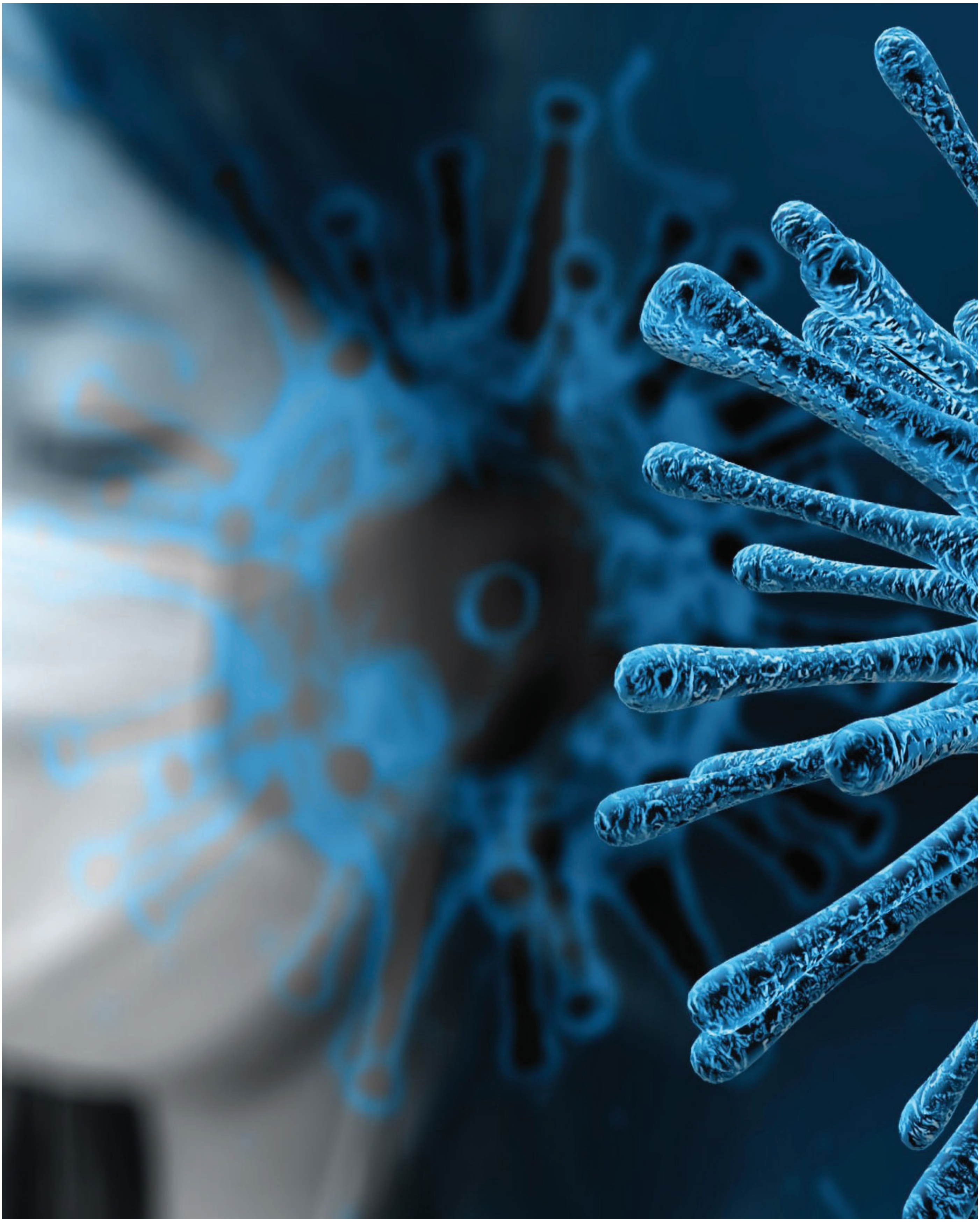
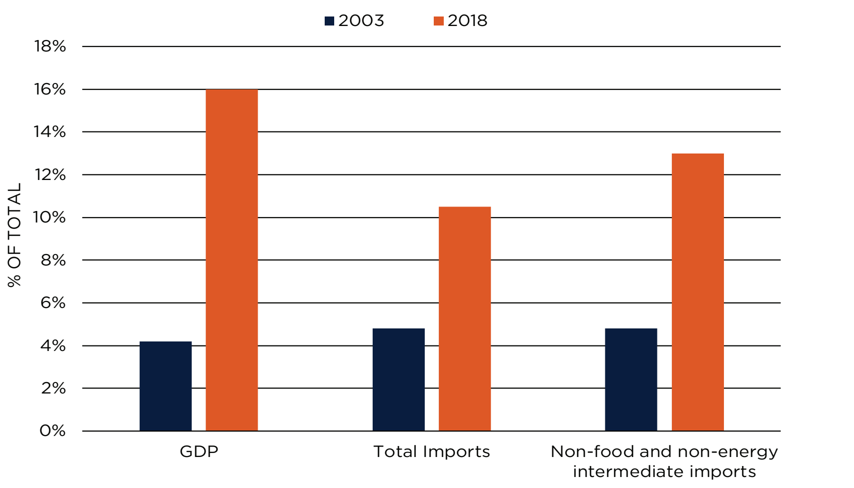


Negotiating an Ancient Disruptor – COVID-19's Impact on Property Markets

SUMMARY

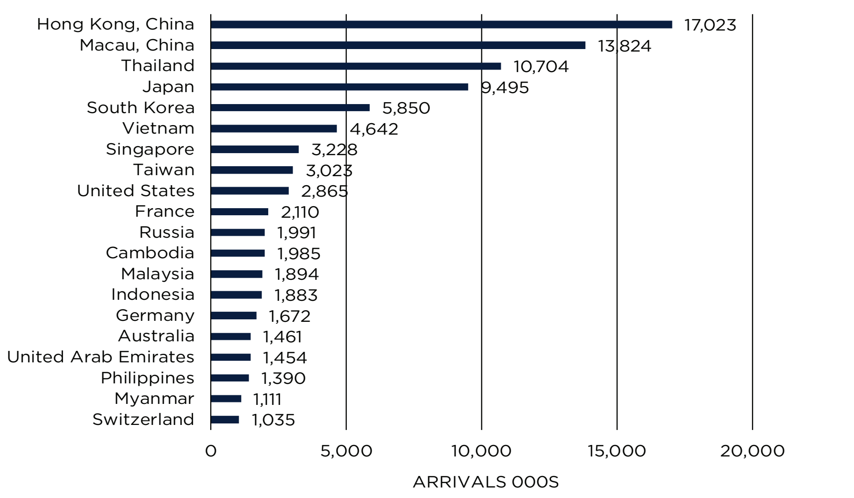
- Coming as it has, during a period of trade tension and social unrest, COVID-19 has piled yet more pressure on the local economy and weakened prospects for the local property market.
- Hardest hit have been the retail and hospitality sectors followed by offices and industrial space while the residential market has not been immune.
- Plenty has been written about the similarities with SARS in 2003 and there are some – both came after a series of economic blows, both originated in China but quickly spread to Hong Kong.
- SARS, however, came when the property markets were in a trough rather than the broadly peak conditions we see today and while COVID-19 could cause widespread economic and social disruption, it appears to be mercifully less lethal than SARS.
- China today has a much greater role in the global economy and to disrupt China is to disrupt the world with consequences for manufacturing and investment far beyond Asia.
- It seems possible, however, that the new virus may follow a timeline similar to SARS and recede rapidly in the warmer summer months after which a return to normality could be swift.
- Signs of widespread distress in the investment market have so far not materialized and many landlords will have decided to wait this one out if their holding power allows.
- Market fundamentals are unchanged with negative real interest rates, chronic under supply and ample liquidity.
- An outbreak which lasts beyond June, a pandemic or further mutation are all factors which could change market dynamics quite quickly and result in a broader sell off.
- Rents have had to react to market conditions and commercial landlords have generally been open to consider at least short term relief measures for tenants.
- Previous government measures aimed at heading off an asset bubble remain in place and could be unwound if necessary, while new relief measures could be introduced.
- Some impacts may be longer term, accelerating technology-driven changes in the ways we live, work and shop, while other effects are likely to prove to be only temporary.

GRAPH 1: China's Importance to the World Economy



Source Oxford Economics/Haver Analytics

GRAPH 2: Top 20 Destinations for China's Outbound Travel, 2019



Source Tourism Economic

THE CURRENT LANDSCAPE – MANY UNKNOWNS STILL

The recent twists and turns of the property market have been dictated first by the trade war, then the social unrest and now by a Novel Coronavirus similar to the common cold but with a mortality rate higher than seasonal flu. Together these events have succeeded in putting Hong Kong's economic growth into a tailspin and prompted cracks to appear in a hitherto robust property market. Hardest hit has been retail and hospitality, but offices and industrial premises are now also showing clear signs of weakness, as is the residential market.

How will the Coronavirus develop? The best anyone can do is to look at the SARS outbreak in 2003. SARS is/was a close cousin of the Wuhan virus but less infectious and with a much higher mortality rate (9% versus an estimated 1-2%). SARS began in Guangdong Province in November 2002, came to Hong Kong in February 2003 and had gone by June/July as the weather warmed, tragically taking 300 lives. If this outbreak is similar, we can expect the worst economic damage to occur over the first half of the year with a swift recovery in the second. SARS peaked in around March/April.

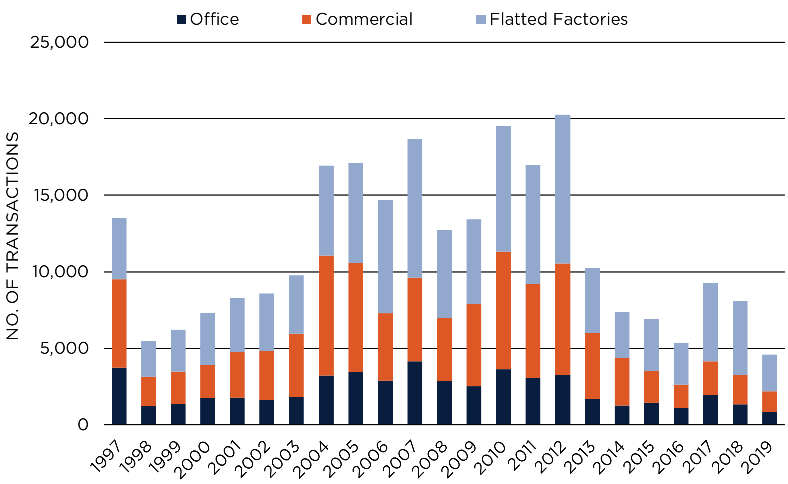
But despite the similarities there are many ways in which history will not be repeated. The Coronavirus has infected a far greater number of people over a much larger area. SARS infected 5,327 in China, 1,755 in Hong Kong and a total of

8,422 worldwide, in contrast the Wuhan virus has already infected over 70,000 in Mainland China alone. At the time of writing the question is whether the Coronavirus will gain a foothold outside China not just in Asia but also in Europe or North America. A pandemic would obviously have terrible implications for an already fragile global economy still recovering from the 2008 financial crisis.

The other major difference is China. In 2003, China was less integrated into global supply chains, less significant as a source of tourists, less of an investor in cross-border real estate and less of a consumer of everything from luxury fashion to cars and fine wines. Whereas in 2003, China constituted approximately 4% of the world economy, that number is now nearer 16%. In 2016 at its peak, China invested almost US$35 billion in overseas real estate markets. The PRC's domestic real estate market is also considerably larger and attracts more international capital than it did in 2003. As the world's second largest economy China's economic health has implications not just regionally but globally as a major importer of raw materials and as a manufacturing and exporting powerhouse. According to the IMF, China accounted for 39% of world economic expansion in 2019.

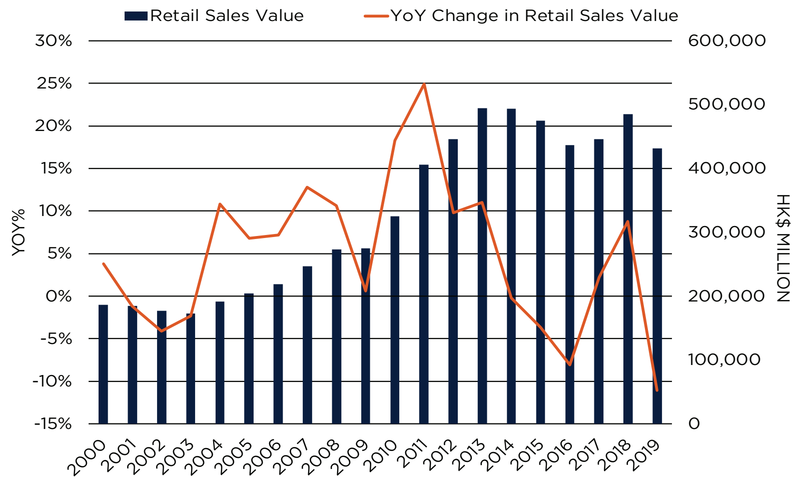
At the time of writing there are still many unknowns including how to effectively treat the disease and how quickly it might spread. Different property sectors are responding very differently and effects will be both temporary and long-term.

GRAPH 3: Non-residential Transaction Volumes, 1997 to 2019



Source Rating and Valuation Department

GRAPH 4: Hong Kong Total Retail Sales, 2000 to 2019



Source Census and Statistics Department, Savills Research & Consultancy

Today the importance of China for Hong Kong is evident across almost all sectors of the economy from trade and tourism to finance and real estate. It follows that anything which restricts China's access (businesses, tourists or investors) to Hong Kong will eventually have implications for property values. Bearing this in mind, we have looked at each of the major real estate asset classes below and attempted to predict how 2020 will play out.

But before looking at the sectors it is worth pointing out that the broader economic context was very different during SARS although, uncannily, that particular epidemic also arrived after a series of economic blows including the 1997/8 Asian Financial Crisis, the bursting of the dotcom. bubble and the Iraq War which began in March 2003. From 1998 to 2002 prices and rents fell steadily and by 2003 weak markets capitulated, dropping further over the first half of the year. SARS was unprecedented, few knew at the time how it would develop, and confidence was quickly undermined. Its disappearance in June, however, combined with a series of supportive government measures including the Individual Visitor Scheme and CEPA, resulted in a rapid market turnaround and a property rally which lasted until 2008. Those confident enough to brave the market in 2003 saw handsome capital gains.

SALES & INVESTMENT

Today's fundamentals remain broadly supportive of values given negative real interest rates, chronic undersupply and ample liquidity. Indeed, Government's main concern over recent years has been to constrain price growth as Hong Kong has held on stubbornly to its crown as one of the world's most expensive

TABLE 1: Impact Of SARS Outbreak On The Economy And Property Prices / Rents

IMPACT ON THE ECONOMY	IMPACT ON THE PROPERTY MARKET (1H/2003)
Q2 GDP growth: -1.6% y-o-y Jun 2003 Unemployment rate: 8.5%	Grade A office rents: -11% Grade A office prices: -5%
1H/2003 visitor arrivals: -20.7% 1H/2003 retail sales: -6.7%	Prime shopping centre rents: -3% Prime street shop rents: -7% Prime street shop prices: -1%

Source Savills Research & Consultancy

TABLE 2: Residential Volumes, 1H/2020E, 2H/2019, 1H/2003, 2H/2002

	1H/2020E	2H/2019	1H/2003	2H/2002
Primary	8,518 (-0.6%)	8,569	10,202 (-0.6%)	10,268
Secondary	14,202 (-15.0%)	16,708	18,520 (-15.0%)	21,785
Total residential	**22,720 (-10.1%)**	**25,277**	**28,722 (-10.4%)**	**32,053**
Office	297 (-4.1%)	310	766 (-4.1%)	799
Retail	550 (-3.5%)	570	1,534 (-3.5%)	1,589
Industrial	762 (-9.2%)	839	1,643 (-9.2%)	1,809
Total non-residential	**1,609 (-6.4%)**	**1,719**	**3,943 (-6.1%)**	**4,197**

Source Savills Research & Consultancy

real estate markets. To this end there are still a slew of measures in place to rein in values and head off a major asset price bubble and these could easily be unwound. New relief measures could always be put in place. Even with the new virus, many owners know that SARS, though devastating, was a temporary phenomenon and will be hoping that this time round we will see a similar pattern. For this reason, they may shy away from bigger discounts of 10% or more.

But cracks have begun to appear. The effects of the trade war have been felt particularly in southern China and manufacturer-investors from the region made noticeably fewer forays into the SARs property markets in 2019. The social unrest meanwhile undermined the mainland-dependent retail and hospitality industries during the second half of 2019 with the Coronavirus and subsequent border closures proving to be the final straw for the sector in January/February 2020. Financial and professional services held up well last year, but operational challenges and the likely shelving of many IPOs can be expected to take their toll in 2020. If the virus were to last beyond June or were to reoccur, mutate or become a pandemic, then the likelihood of substantial price discounts would increase substantially.

RETAIL

This sector has been in decline since 2013/14 (the Occupy movement) but prices have fallen at a slower rate than rents as many landlords have considerable holding power and will rather discount rents to fill units than feel the need to drop prices sharply to dispose of assets. Shopping mall landlords are offering tenants temporary relief with some giving as much as 30% to 60% discounts for the next month or two.

Looking beyond the virus, lower taxes in the Mainland, a weaker Renminbi, lingering issues surrounding the social unrest (which remain unresolved) and more competition for mainland tourists from other destinations are reasons to think that the sector has a tough time ahead of it and that previous highs will not be reached. The virus may also accelerate the switch to online with negative implications for physical stores although Hongkongers will always regard shopping and shopping malls as a major pastime and online may never make quite the same inroads it has elsewhere in China.

OFFICES

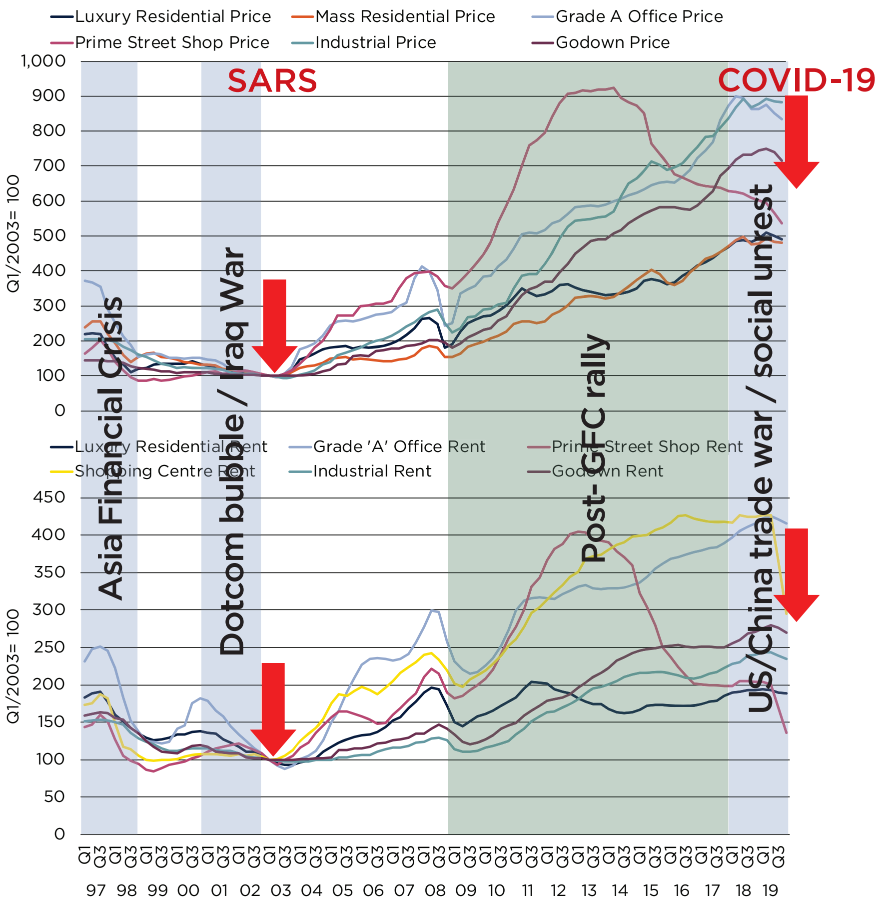
Prices here are notoriously volatile and driven by speculators, end users and opportunistic or value add funds. Values have hit historical highs and some discounting was already in evidence prior to the outbreak but there are few signs of distress and the more significant 10% plus discounts have not been in evidence. Expect volumes to remain extremely thin, though, particularly over the first half.

Leasing demand has been driven by PRC firms particularly core-focused finance-related businesses, but demand has been broadening to include sectors such as, for example, retail and professional services. The social unrest had already been undermining that demand when the outbreak occurred and today, little is happening.

The other driver of office take-up has been co-working operators, especially in fringe-core locations and areas with a high degree of amenity such as Causeway Bay with ample provision of retail, hotels etc. In the short term the appeal of shared space has diminished for obvious reasons, but longer term, a greater familiarity with remote working may spur demand again if the underlying business model proves durable.

Even before the outbreak, we were reporting rental declines in Q4 as co-working demand withered and submarkets exposed to tourist, retail or trade related businesses began to see falls as a consequence of the unrest. The

GRAPH 5: Hong Kong Price and Rental Indices, Q1/1997 to Q4/2019



Source Savills Research & Consultancy

IPO market was previously seen as more positive for Central office rents but, in light of recent events, it seems probable that many new listings will be postponed with knock on effects on the finance and professional services sector and demand for new space. There is some good news for landlords; supply this year will be extremely limited.

LUXURY RESIDENTIAL

One of the big questions is what impact the Coronavirus will have on Hong Kong's indomitable housing market. Even as the trade war has raged and social unrest has torn the city apart, prices have continued to rise even if volumes have had to bear the brunt. We believe that the outbreak is unlikely to prompt a sharp correction unless it continues beyond June as, with experience of SARS, most people know that this unfortunate event is more than likely to be temporary. Fundamentals including negative real interest rates and limited supply will continue to support values in the medium term. Volumes can be expected to remain low as primary market activity, which has driven transactions over the past 12 months, dwindles due to a lack of new launches.

INDUSTRIAL

China's well developed and extensive supply chains have been comprehensively disrupted by the Coronavirus and the prolonged closure of factories combined with strict quarantine measures means that this situation will continue for some time. A greater reliance on online retail will have some offsetting effect. Once the outbreak ends, however, a return to normality can be expected after an initial demand surge as businesses and individuals restock.

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For more information about this report, please contact us

Savills Research

Simon Smith
Senior Director, Head of Research & Consultancy
+852 2842 4573
ssmith@savills.com.hk

Jack Tong
Director
+852 2842 4213
jtong@savills.com.hk

Desmond Ho
Manager
+852 2842 4270
deho@savills.com.hk