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30 December 2010

Ms Anita Sit
Clerk to Panel
Legislative Council
8 Jackson Road
Central
Hong Kong

Dear Ms SIT,

Panel on Financial Affairs
Request for information on commercial and industrial property markets

I refer to your letter dated 6th December, 2010 to the Financial Secretary. The requested information is enclosed herewith as **Annex** for Members' information.

Development of the commercial and industrial property markets is related to land supply. On this front, the Development Bureau has strived to ensure a steady and adequate provision of land to meet various future needs. If Members wish to further pursue the issue, the subject can be taken up in the context of the Panel on Development.

We would also like to take this opportunity to thank members for their interests in this subject.

Yours sincerely,

(Ms Jessie Wong)
for Secretary for Financial Services and the Treasury

cc Hon CHAN Kam-lam, SBS, JP (Panel Chairman)
Mr Arthur AU, Administrative Assistant to Financial Secretary
(Fax : 2840 0569)
Ms. Amy CHAN, Administrative Assistant to Secretary for Development
(Fax : 2147 3691)
Mrs Helen CHAN, Government Economist (Fax : 2866 8869)

Information note on commercial and industrial property markets

Introduction

1. This note provides background information on the commercial and industrial property markets, and elucidates the Government's related policy.

The commercial and industrial property markets

2. For analytical purpose, commercial and industrial property covers office space, commercial property (mainly retail shop space) and flatted factory space in this paper. Storage, specialised factory and industrial/office space are however excluded, given their relative unimportance and the absence of relevant information.

(a) Office space[(1)]

3. The total stock of office space increased noticeably from 9.0 million m^2 at end-1999 to 10.5 million m^2 at end-2009[(2)] (***chart 1(a)***). Annual average net completion (i.e. completion net of demolition) amounted to 173 900 m^2 during 2000-2009[(3)], though actual net completion varied from year to year. In line with the progressive transformation of the Hong Kong economy towards higher value-added activities, almost 90% of the net completion over the past ten years were Grade A office space, bringing its share in total stock of office space from 57% at end-1999 to 62% at end-2009. Looking forward, gross completion is forecast at 252 300 m^2 in 2010 and 2011 combined, of which over 85% are Grade A office space.

4. During 2000-2009, take-up averaged at 191 900 m^2 per year. Take-up had remained generally strong since 2003 along with sustained economic growth, before turning negative in 2009 following the global financial crisis. As annual take-up was larger than annual net completion, the vacancy rate declined noticeably from 14.0% at end-1999 to 10.3% at end-2009 (***chart 1(b)***).

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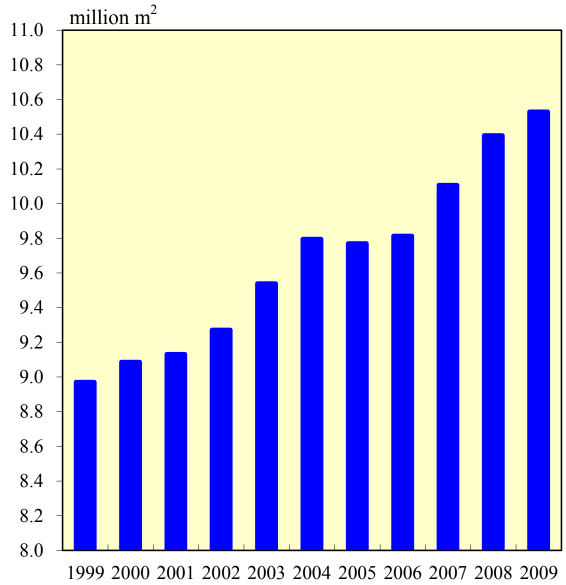
(1) Office space includes premises situated in buildings designed for commercial/business purposes. Offices owned by the Government and managed by the Government Property Agency are excluded.

(2) All areas in this note are expressed in terms of internal floor area.

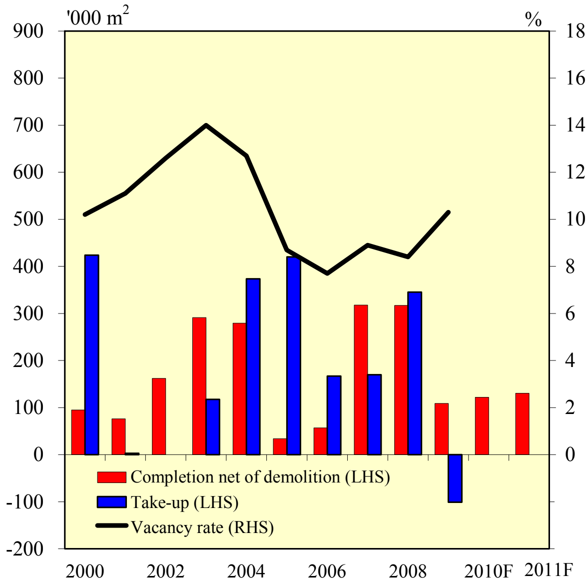
(3) The change in stock from end-1999 to end-2009 does not equal the cumulative net completion during 2000-2009, as there might be conversion into/from other uses during the period.

Chart 1(a) : Total stock of office space



Source : Rating and Valuation Department.

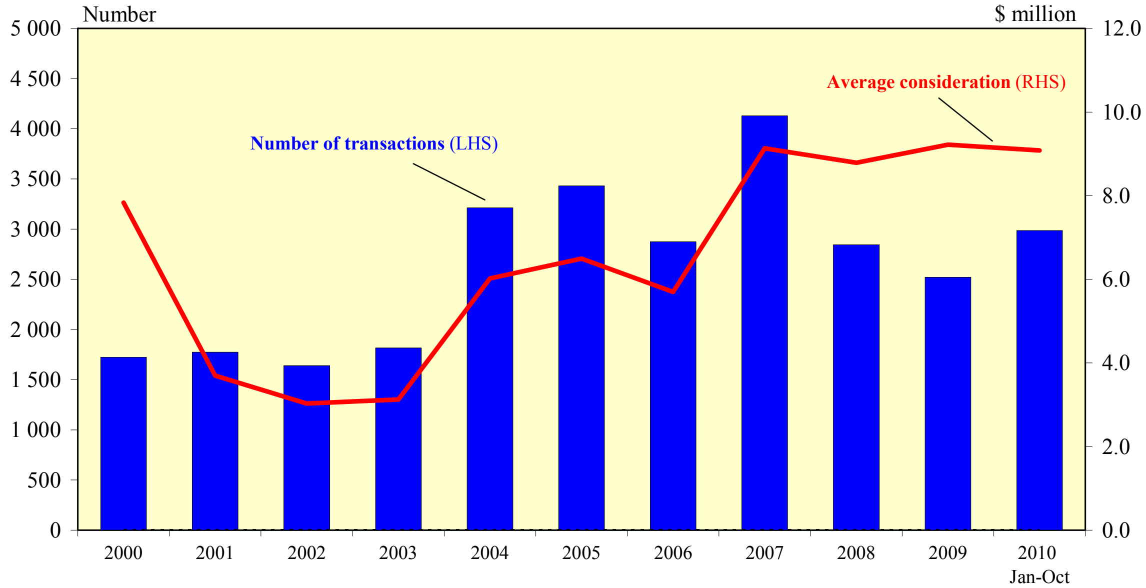
Chart 1(b) : Completion net of demolition, take-up and vacancy rate for office space



Note : Figures for 2010 and 2011 refer to forecast completion.

5. On trading, there were on average 2 600 office space transactions per year during 2000-2009, compared with 90 100 transactions per year for residential units. Investment in office space usually involves a larger amount of capital than investment in residential property, as reflected by the larger average consideration for office space transactions, at $9.1 million in the first ten months of 2010, than that for residential property transactions, at $4.1 million. Looking at individual years, trading rose noticeably during 2004-2007 on the back of solid take-up. It then moderated in late 2008 and early 2009 amid the global financial crisis, before reviving in mid-2009. In the first ten months of 2010, transactions of office space jumped by 53% over the low base a year earlier to 3 000 (***chart 2***). This corresponded to a monthly average of 300 transactions, not particularly hectic when compared with the average of 270 transactions per month during 2004-2008 (i.e. the 5-year period before the global financial crisis).

Chart 2 : Total number of transactions and average consideration for office space

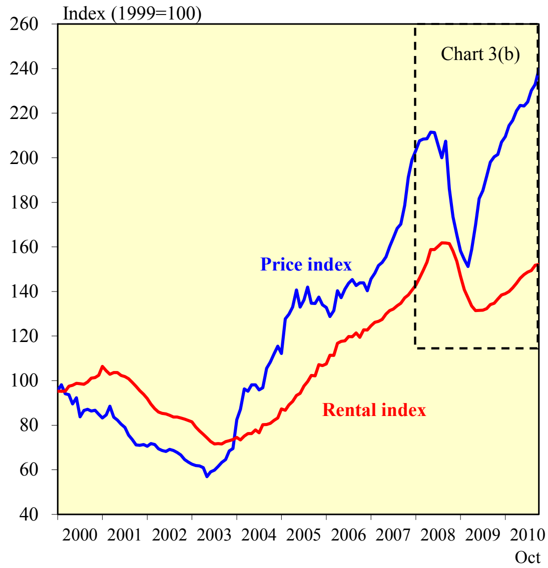


Source : Rating and Valuation Department.

6. Between December 1999 and December 2009, prices of office space rose by an average of 8.0% per year. Rentals recorded a much more modest gain of 3.6% per year. After the protracted consolidation which ended in 2003, prices and rentals of office space had been generally on an uptrend until the outbreak of the global financial crisis led to a plunge in the second half of 2008 (***chart 3(a)***).

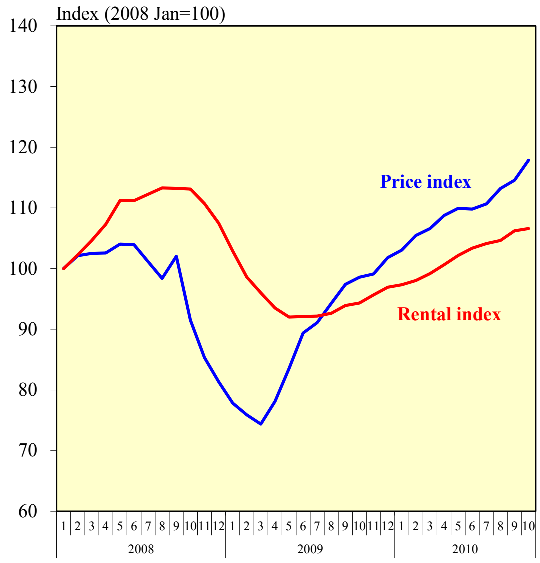
7. On the back of abundant liquidity, extremely low interest rates and sustained economic recovery, the office space market has staged a sharp rebound since early 2009. Prices of office space in October 2010 surged by 58% over the recent bottom in March 2009, and have surpassed the 2008 peak by 13%. Meanwhile, rentals have rebounded by a more moderate 16% from the bottom, and were still 6% lower than the peak in 2008 (***charts 3(b)***).

Chart 3(a) : Price and rental indices for office space since 2000



Source : Rating and Valuation Department.

Chart 3(b) : Price and rental indices for office space since 2008



(b) Commercial property[4]

8. The total stock of commercial property rose from 8.9 million m^2 at end-1999 to 10.7 million m^2 at end-2009, among which around 0.8 million m^2 was due to the inclusion of property owned by the Link Real Estate Investment Trust (REIT) since 2006[5] (***chart 4(a)***). Over the past ten years, net completion of commercial property[6] amounted to an average of 86 100 m^2 per year. Yet over 80% of these were realised in 2001-2006, and completion over the past three years were relatively low. Looking forward, gross completion in 2010 and 2011 combined is forecast at 137 600 m^2.

9. Over the past decade, take-up of commercial property averaged at 75 100 m^2 per year, though performance likewise varied in different years. On the back of vibrant inbound tourism, take-up was robust during 2005-2007. Then the global financial crisis in late 2008 and the heightened risks of swine flu in mid 2009 led to a visible decline in the ensuing two years. The

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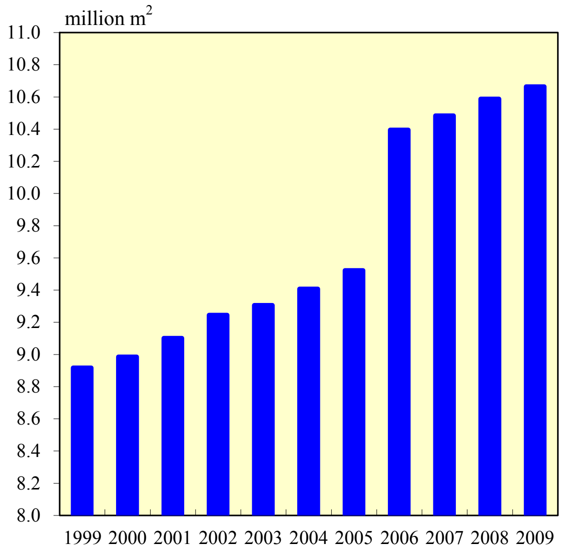
(4) Commercial property includes retail shop space and other premises for commercial uses but excludes office space. Also excluded are carparking space and commercial premises owned by the Housing Authority and Housing Society.

(5) Following the divestment of selected commercial Housing Authority premises to the Link REIT in November 2005, the related properties owned by the Link REIT are classified as private sector properties and are included in the statistics from 2006 onwards. Before 2006, such properties were owned by the Housing Authority and were hence not included in the statistics.

(6) See footnote (3) for explanation on the possible discrepancy between change in stock and cumulative net completion.

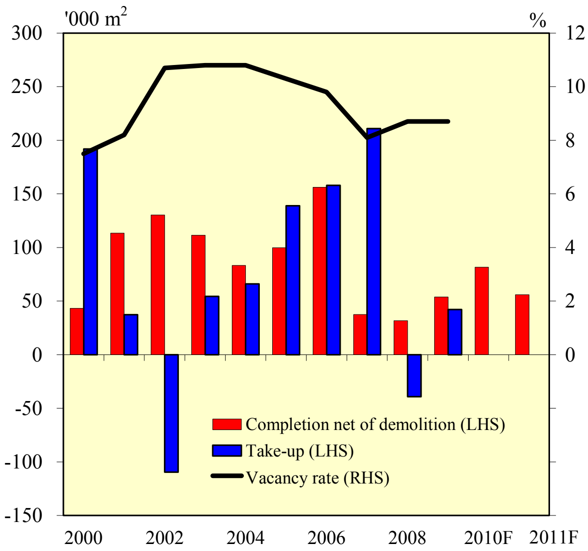
vacancy rate stayed relatively high during most of the past ten years, only down slightly from 9.2% at end-1999 to 8.7% at end-2009 (***chart 4(b)***).

Chart 4(a) : Total stock of commercial property



Note : The hike in 2006 was due to the inclusion of the commerical properties under the Link REIT from 2006 and onwards.
Source : Rating and Valuation Department.

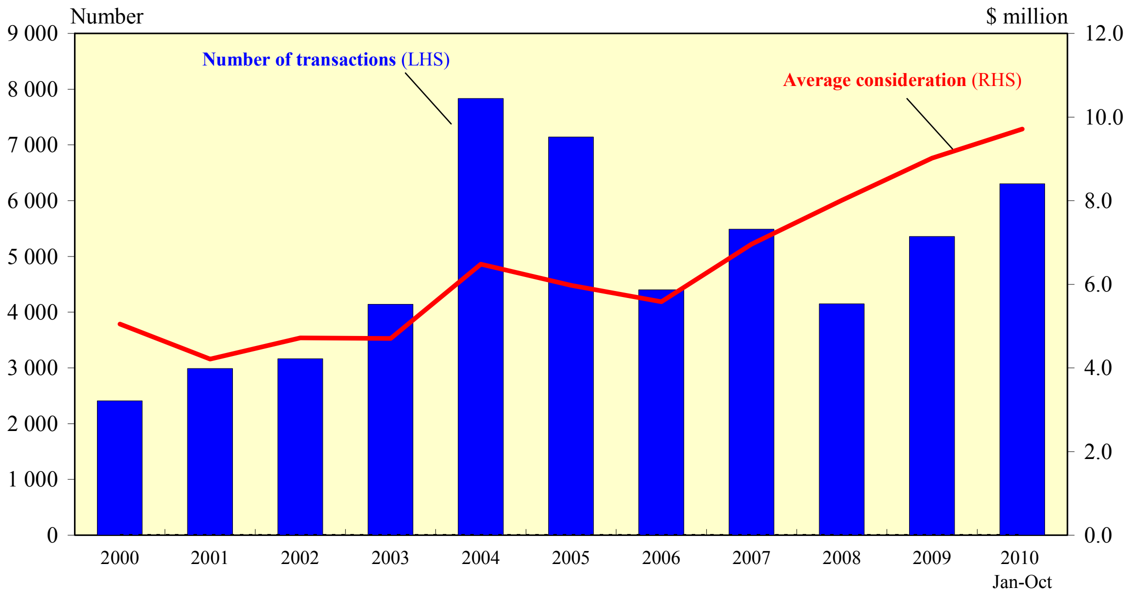
Chart 4(b) : Completion net of demolition, take-up and vacancy rate for commercial property



Note : Figures for 2010 and 2011 refer to forecast completion.

10. There were on average 4 700 transactions for commercial property per year during 2000-2009, compared with 90 100 transactions for residential property per year. Similar to transactions for office space, the average consideration for commercial property transactions, at $9.7 million in the first ten months of 2010, was significantly larger than the average consideration for residential property transactions, at $4.1 million. Statistics shows that trading of commercial property is rather sensitive to the economic situation. Amid the global financial crisis, transactions plunged in late 2008 and early 2009, but rebounded sharply in mid-2009 and remained hectic thereafter. In the first ten months of 2010, the number of commercial property transactions rose by 50% over the low base a year earlier to 6 300 (***chart 5***). This translated into an average of 630 transactions per month, as compared with the monthly average of 480 transactions during 2004-2008 (i.e. the 5-year period before the global financial crisis).

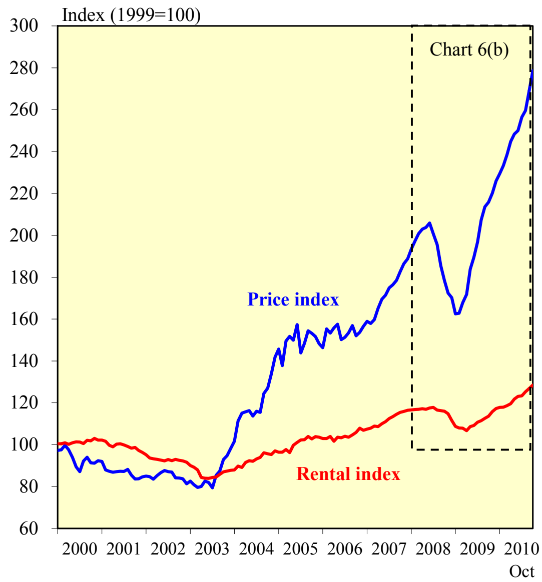
Chart 5 : Total number of transactions and average consideration for commecial property



Source : Rating and Valuation Department.

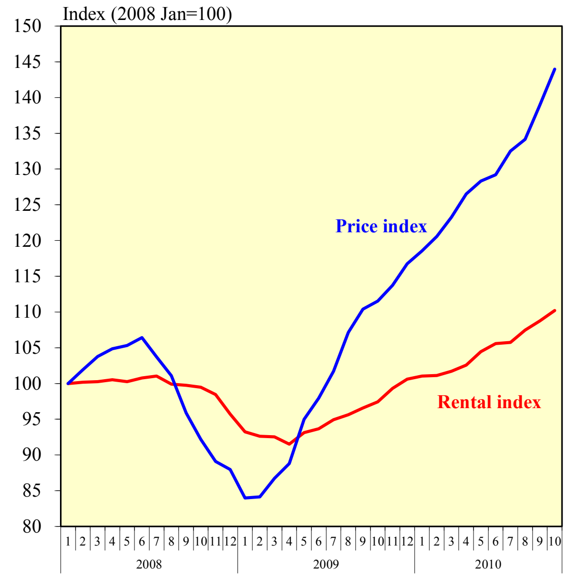
11. Between December 1999 and December 2009, prices of retail shop space rose by an average of 9.0% per year, while rentals edged up by only 1.4% per year. In general, both shop prices and rentals are highly sensitive to economic cycles (***chart 6(a)***). Hit by the global financial crisis, prices of retail shops dropped by a sharp 21% during the second half of 2008, but have rebounded by a profound 71% since then. In October 2010, prices of retail shops were already 35% higher than the recent peak in 2008. By contrast, rentals of retail shops fell by a more modest 9% during the global financial crisis, and also rebounded by 20% after hitting the bottom. In October 2010, rentals of retail shops were 9% higher than the recent peak in 2008 (***chart 6(b)***).

Chart 6(a) : Price and rental indices for retail shop space since 2000



Source : Rating and Valuation Department.

Chart 6(b) : Price and rental indices for retail shop space since 2008



(c) Flatted factory space[7]

12. In contrast to the situation regarding office space and commercial property, the total stock of flatted factory space decreased, albeit marginally, from 17.7 million m^2 at end-1999 to 17.3 million m^2 at end-2009 (***chart 7(a)***). In face of the declining importance of manufacturing in the Hong Kong economy, many owners of flatted factory space preferred redeveloping/converting the premises for other more valuable uses. As a result, net completion of flatted factory space was either negligible or even negative throughout the past decade[8]. Looking forward, gross completion is nonetheless forecast to rebound to 107 900 m^2 in 2010 and 2011 combined.

13. During 2000-2009, take-up of flatted factory space averaged at only 44 000 m^2 per year. Yet against the background of a dwindling stock, the vacancy rate for flatted factory space still declined from 9.7% at end-1999 to 8.0% at end-2009 (***chart 7(b)***).

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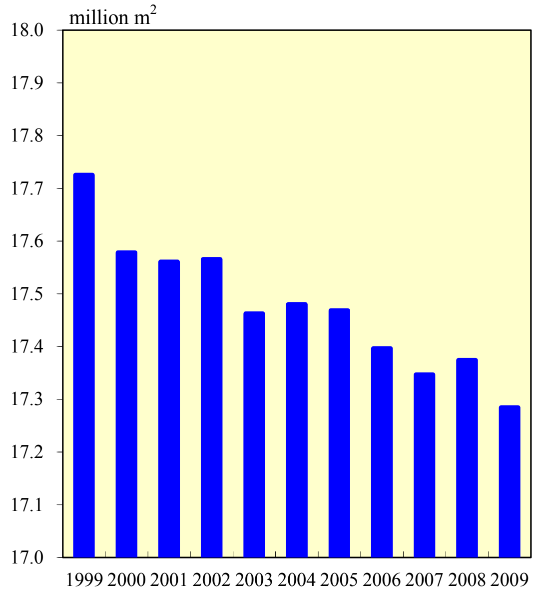
(7) Flatted factory space includes premises designed for general manufacturing processes and uses, including office, directly related to such processes. Specialised factories and similar premises built by the Housing Authority are not included.

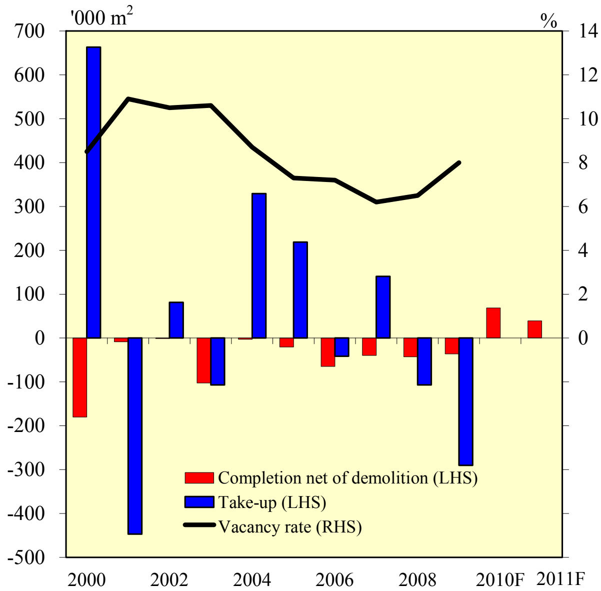
(8) See footnote (3) for explanation on the possible discrepancy between change in stock and cumulative net completion.

Chart 7(a) : Total stock of flatted factory space



Source : Rating and Valuation Department.

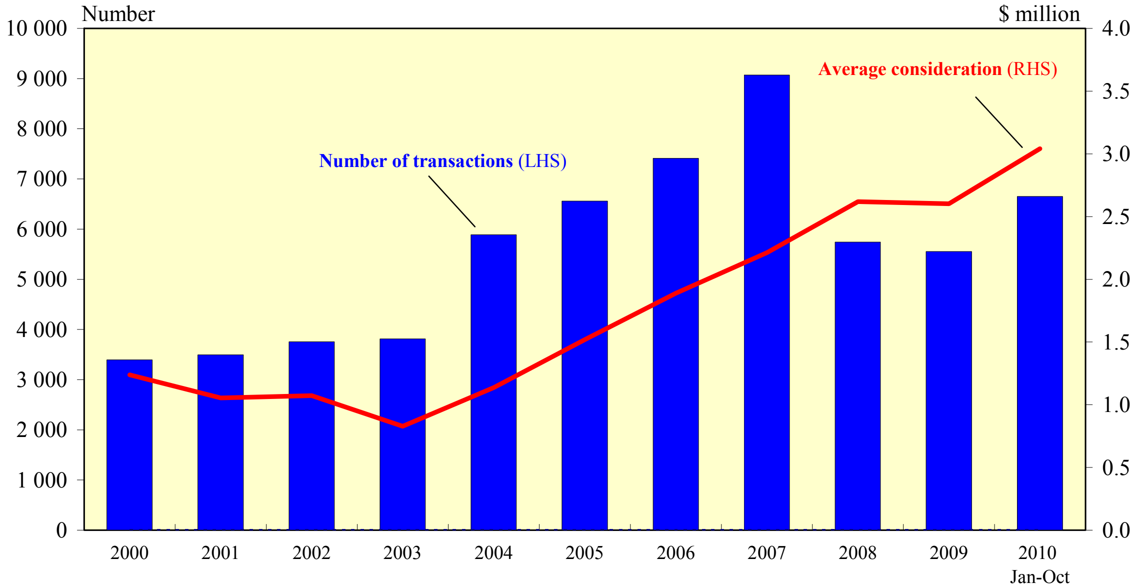
Chart 7(b) : Completion net of demolition, take-up and vacancy rate for flatted factory space



Note : Figures for 2010 and 2011 refer to forecast completion.

14. There were on average 5 500 transactions for flatted factory space per year over the past decade, smaller than the average of 90 100 transactions for residential property per year. Average consideration for flatted factory space transactions, at $3.0 million in the first ten months of 2010, was smaller than that for residential property, at $4.1 million. Similar to other types of property, transactions for flatted factory space retreated in 2008 and early 2009 alongside the global economic downturn, but then recovered in 2009 and 2010. In the first ten months of 2010, the total number of transactions for flatted factory space surged by 59% over a year earlier to 6 700 (***chart 8***). This was equivalent to an average of 670 transactions per month, not particularly out of line from the monthly average of 580 transactions during 2004-2008 (i.e. the 5-year period before the global financial crisis).

Chart 8 : Total number of transactions and average consideration for flatted factory space



Source : Rating and Valuation Department.

15. Prices of flatted factory space rose by an annual average of 9.9% between December 1999 and December 2009, but rentals were basically flat, with a marginal increase of 0.5% per year (***chart 9(a)***). During the global financial crisis in late 2008, prices of flatted factory space fell by a sharp 23%, while rentals retreated by 14%. As a result of the 56% rally since early 2009, prices of flatted factory space in October 2010 have exceeded the recent peak by 20%. As to rentals, in October 2010 they have rebounded by only 16% from the recent bottom and were still marginally below the recent peak in 2008 (***chart 9(b)***).

Chart 9(a) : Price and rental indices for flatted factory space since 2000

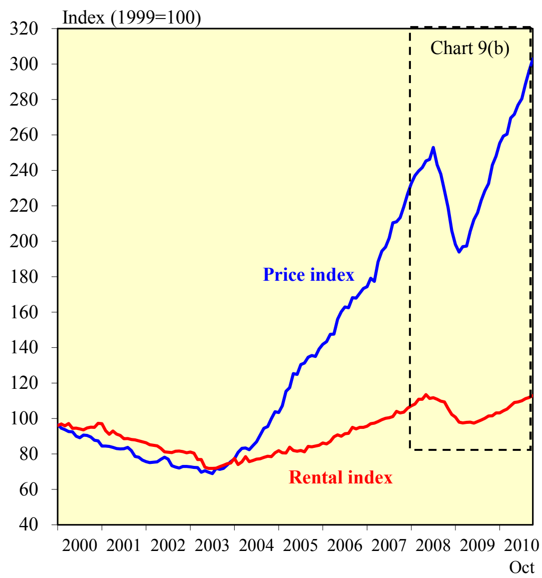
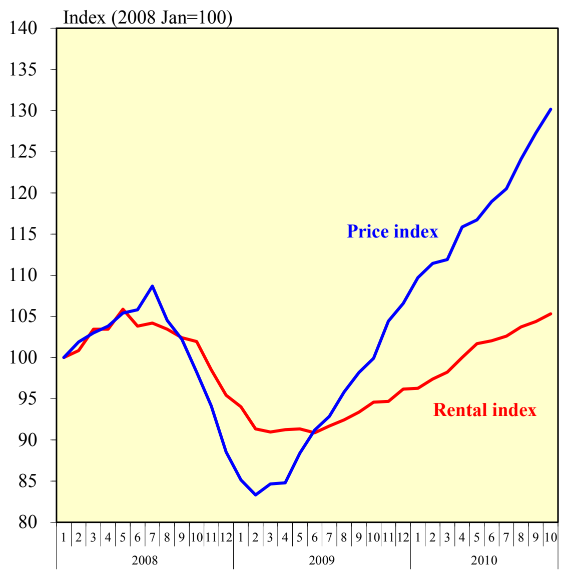


Chart 9(b) : Price and rental indices for flatted factory space since 2008



Source : Rating and Valuation Department.

The Government's policy towards the commercial and industrial property markets

16. Transactions for non-residential property are essentially commercial activities. Statistics shows that over the past ten years there were on average 2 600 transactions for office space, 4 700 transactions for commercial property and 5 500 transactions for flatted factory space per year, much smaller than the average of 90 100 transactions for residential property per year. Also, investment in commercial properties generally requires much larger amount of capital. Average consideration per transaction during the first ten months of 2010 was $9.1 million for office space and $9.7 million for commercial property, versus $4.1 million for residential property. It is thus highly unlikely that a typical household would invest in non-residential property on a significant scale. The repercussions of a wild fluctuation in prices of non-residential property on macroeconomic and financial stability are hence much less substantial than the residential segment.

17. As for the concern about rising rentals which would eventually be reflected in business costs of the various economic activities, it is worth noting that while prices of office, retail shop space and flatted factory space all rose quite notably over the past ten years or so, rentals of office and retail shop space showed much more modest increases, at 3.6% and 1.4% per annum respectively. Rentals of flatted factory space were generally flat over the period.

18. When faced with huge capital flows, the Government's policy focus is to safeguard against a build-up in systemic risks, with a view to ensuring macroeconomic and financial stability. Indeed, the Hong Kong Monetary Authority's recent mortgage-tightening measures also include the lowering of the maximum Loan-to-Value ratio for mortgages of all industrial and commercial property to 50%. The Government will ensure that the financial institutions remain prudent in extending loans, and forestall credit expansion and asset price inflation forming a vicious circle, thereby reducing the possible shocks in the event that capitals retreat.

19. Balancing the macroeconomic risks involved against an equally important objective to ensure a conducive business environment under a free market setting, the Government is of the view that investment in non-residential property is essentially a commercial activity that should be best left to the market.

20. As to the supply of land, to support economic growth in the long run, major land use requirements were examined in the Hong Kong 2030 Study and appropriate planning measures were recommended to meet future needs. The Study has stressed the importance of maintaining a steady and adequate supply of Grade A office so as to sustain Hong Kong as a leading financial centre and regional business hub. We will continue to increase supply mainly through freeing up government accommodation not requiring a prime location and developing new office clusters at strategic locations in the metro areas like Kai Tak and West Kowloon. The demand for other general business use including non-prime offices and traditional industry/warehouse uses is expected to be largely met by revitalisation of older industrial areas and development of other office clusters outside prime locations. The initiatives to revitalise older industrial buildings through redevelopment and wholesale conversion to non-industrial uses, introduced in April 2010, will stimulate the provision of suitable land and premises at more affordable prices to support various business needs. We will continue to monitor the land supply for major land uses to ensure our planning strategy is robust enough to cope with changing circumstances.

28 Dec 2010