Hong Kong expert

A roundtable discussion on Hong Kong's economy and property markets

with Dr Jennifer Molloy

Hong Kong is a global business hub with robust property markets. As such, it attracts institutional investors from around the world. But it is also one of the world's most expensive places to live, work and construct assets. Recently, *Institutional Real Estate Asia Pacific* senior editor **Jennifer Molloy** asked a number of experts on Hong Kong their opinions about the territory, and their responses are collected below. The roundtable discussion includes **Marc-André Flageole,** global portfolio manager – head of the investment team, with Presima; **Andrew Moore,** principal and CEO, Pamfleet; and **Richard Yue,** CEO and CIO, Arch Capital Management Co.

This past March, Carrie Lam was elected chief executive of Hong Kong, the first woman to hold that post. What does this mean for Hong Kong's economy, property markets and institutional real estate investors?

Moore: Carrie Lam is the fourth chief executive of Hong Kong since sovereignty returned to China 20 years ago. Her vision for Hong Kong — from her election manifesto — is a vibrant international metropolis that is just, civilised, safe, affluent, enjoys the rule of law, is compassionate and well-governed. She was elected chief executive because she has the trust of Beijing, and I have no doubt Hong Kong will be stronger if it works with China and not against it. Carrie Lam is an accomplished and widely-respected government official, with good networks; however, she now

takes the top job in a dysfunctional political system with a government culture that makes decision making and implementation extremely difficult. She will need to work hard and be smart to deliver on her policy pledges but, overall, I am optimistic that she will be a very good chief executive.

Flageole: For the property market and institutional real estate investors, the direction of Carrie Lam's policies should largely echo the heritage of predecessor CY Leung, at least in the short term. The new administration would want to maintain the pressure to cool down residential property prices and avoid an additional spike in prices. From a public-opinion standpoint, a deterioration of already-poor home affordability would be perceived negatively, and Carrie Lam might be sensitive to the issue.

Yue: Carrie Lam was previously the Secretary for Development for many years and tackled many important issues in the housing market. She has always favoured urban renewal, and her policies address the long-term needs of Hong Kong. She clearly has a good understanding of the property market in Hong Kong, so we should all benefit having her as our chief executive.

Flageole: The approach to trying to control home prices might, however, evolve slightly under the Lam administration. In an effort to increase the supply of new homes, Ms Lam might be more open to negotiating with developers to convert their farmland into residential development sites. This potential has been talked about for years but has failed to materialise in a significant way. A matter of weeks into the new administration, the government was, for instance, able to negotiate a fee for the conversion of a significant site with Sun Hung Kai Properties. This is, perhaps, a sign Carrie Lam is more open and flexible to make the conversions work, and that she is focused on increasing home supply to control prices.

Let's discuss Hong Kong's property sectors. What are the opportunities and challenges in the office sector?

Yue: Hong Kong has greatly benefited from China's growth and is expected to continue to play an important role as the gateway for China's interest to the world. The office market is expected to do well. Limited supply in the centralised area is expected to keep costs high. The flow to decentralised markets — such as Quarry Bay and Kwun Tong/Kowloon Bay, or CBD2 — will help alleviate the cost issue. However, the continual flow of China's interest to Hong Kong will keep the market stable. Higher-quality buildings in decentralised locations will continue to be an interesting play.

Moore: Institutional investors who believe Hong Kong will retain its status as an international business centre and will continue to benefit from closer ties to the mainland might consider well-located secondary office properties that offer a reasonable rental yield and potential for capital appreciation.

Yes, Hong Kong offices are expensive; however, there are many cheaper alternatives. Companies that don't need to be in a HK$130- to HK$180- [US$16.61 to US$23.00] per-square-foot, per-month building in Central can rent grade A space in a decentralised, but readily accessible, location such as Kwun Tong, Kwai Ching or Wong Chuk Hang for as little as HK$20 to HK$30 [US$2.56 to US$3.83]; and there are grade B and C buildings in the CBD for HK$30 to HK$40 [US$3.83 to US$5.11].

This arbitrage means a value-add investment strategy can be highly effective in Hong Kong.

Flageole: The office sector has also seen a pick-up over the last year, with a steady inflow of mainland Chinese firms opening new branches in the Hong Kong market. The Central office market continues to be solid, with very limited vacancy and slightly-accelerating rent reversions. Decentralised locations are also benefitting from improved demand, although significant new supply could affect the Kowloon East market.

From an investment-opportunity standpoint, we believe that, while private real estate assets are difficult and expensive to acquire, listed real estate securities might offer efficient access to Hong Kong property at a currently more-reasonable price. Listed developers and landlords own among the top-quality real estate in Hong Kong, yet seem to trade at a significant discount to their book values and net asset values in private markets.

Andrew Moore, Pamfleet

What are your thoughts on Hong Kong's residential sector?

Moore: We like multifamily residential that targets young urbanites. There is little institutional-quality residential for rent in Hong Kong and a huge opportunity to scale branded environments that are practical and fun for their occupants.

Flageole: Residential assets for sale have been a solid sector, with home prices growing by more than 25 percent since their recent mid-2016 bottom. This appreciation has enabled developers with existing land bank and ongoing projects to maintain or increase their profit margins and generate high yields on their investment. With more mainland China developers entering the Hong Kong market and bidding for residential sites, the price of land has been increasing over the last year. Going forward, this might mean that margins on residential developments will be under pressure, with the increased cost of land not entirely passed to the customer.

Yue: Residential prices are also one of the highest in the world. It has been this way for at least the last 25 years and is not expected to change anytime soon. The bulk of the new land supplies are predominantly in the New Territories. Therefore, prices in the urban area are expected to remain strong. This sector is dominated by large local developers with large land banks. This makes it much more challenging for marginal players to enter the residential market.

How about Hong Kong's retail sector?

Flageole: The retail sector, especially in the luxury segment, has been slowing over the last few years, partly due to more limited growth in tourist arrivals from the mainland. However, we now see a marginal pick-up in retail sales, and landlords might be able to stabilise rent reversions, as they have been gradually remixing their tenants away from luxury into more mass-market offerings. Better days could be ahead for Hong Kong retail.

Moore: Hong Kong's prime retail districts are still experiencing high vacancies and falling rentals. Although visitor arrival numbers have recently been increasing and overall retail sales are also up, it may be too early to buy in the core luxury sector. However, some local neighbourhood retail centres offer good income and capital growth potential, especially where there are upcoming transport initiatives or housing developments to drive demand. The strong domestic economy should continue to underpin such investments.

Yue: We are quite positive on the prime retail districts in Hong Kong, such as TST, Causeway Bay and Central. New supply is limited, and these areas will see the strongest recoveries in retail rent. We like the middle-market consumer goods sector as opposed to the high-street luxury-items sector.

What should institutional investors understand about recent government land sales in Hong Kong?

Moore: Two record-breaking commercial land sales re-energised the office investment market mid-year, prompting several en-bloc and strata deals, including Nan Fung Group's sale of The Wellington in Sheung Wan for HK$3 billion, or HK$30,000 per square foot [US$383 million, or US$3,833 per square foot], the largest whole-building deal of the year through August. These high prices encouraged more owners to bring their properties to market; however, the majority have yet to find buyers. Prospective new investors should be cautious not to jump into the market just because there are plenty of buildings for sale currently.

Yue: Land auction for quality commercial sites in prime urban areas is very scarce in Hong Kong. This explains the strong interest of not only local developers, but also from Chinese developers. Land value is so high in Hong Kong that the land cost component is easily 85 percent to 90 percent of total development costs. This means value creation from correctly betting on the direction of the market is higher than from design and quality execution. This is especially challenging for institutional investors who are return-driven, as a large portion of their capital would be committed upfront in land costs. Developers with a much longer investment horizon have an edge over any foreign institutional investors.

Flageole: One of the main takeaways of recent government land sales prices relates to basic supply and demand dynamics. While supply of land, particularly commercial sites, remains very limited in Hong Kong, new sources of demand have been growing over the last few years. Local developers now face much increased competition from mainland China developers wanting to establish a presence in Hong Kong, often to diversify or improve their company status in China.

It appears the required return and cost of capital of these new investors is lower than for more-established local players, as they are willing to compromise on development margins, and see their investment from a more holistic standpoint. In some cases, it seems the new entrants are seeing their first Hong Kong investments as loss-leaders, again willing to accept lower returns to establish a presence and potentially improve their branding.

This influx of demand might slow in the coming quarters or years, given the tighter capital controls Beijing is trying to implement. Ultimately, developers might need to get used to higher land prices and lower margins, with Hong Kong remaining a sought-after destination for capital.


Marc-André Flageole, Presima

If fundamentals deteriorate significantly, these elevated prices and large lump sums spent by developers might mean trouble. If land purchases are financed with a high proportion of leverage, lower margins and rental yields leave little room for downside. Levered developers might compromise their viability, if too aggressive with large investments for limited expected yields.

What effect are property-market cooling measures in Hong Kong having, and what else should investors understand about the Hong Kong Monetary Authority's actions?

Moore: First, the HKMA's prudential measures for property mortgage loans mainly affect private residential properties; however, commercial properties are also impacted, being subject to a maximum loan-to-value ratio of 40 percent if that loan is from a local, authorised institution. From 1 June 2017, banks have also had to lower the LTV for developers to 40 percent of site value and 80 percent of the construction cost.

Second, government measures to increase stamp duties have been in effect since 2013, and there is little expectation rates will be reduced soon. Residential investment property has been particularly affected, with 15 percent buyer's stamp duty payable in addition to the 8.5 percent standard top rate, plus a further "special stamp duty" if the property is resold within 36 months after acquisition. This means that it is unattractive to buy residential property for investment unless it can be acquired through the purchase of a company holding structure.

Yue: For foreign investors, the additional stamp duty imposes a major disadvantage to investing in Hong Kong. I do not feel that foreign institutional investors are the reason driving up property prices in Hong Kong. If anything, foreign institutional investors represent a small fraction of the transaction volume, historically. I believe that speculation is predominantly at the retail level. The additional stamp duty goes against the laissez-faire culture and the DNA of Hong Kong.

Flageole: So far, property market cooling measures have had limited sustained impact on residential prices, despite relatively short-term corrections in 2013 and 2015. Also, measures did not seem to deter investments from foreign companies and real estate developers, which have been active in purchasing commercial assets and residential sites, especially in recent years. However, it appears the measures have had an impact on speculators and foreign homebuyers, as the proportion of buyers that are local end-users has increased since they were introduced. Also, the measures seem to have had a greater impact on the secondary markets, where transaction volumes have slowed down.

We believe that the HKMA walks on a thin line vis-à-vis property markets. On one side, there is an incentive to keeping the markets healthy and steadily growing to maintain the wealth effect of property and revenues from land sales for the government. On the other side, authorities seem to be dealing with constant pressure from the public, which focuses on poor access and affordability issues. In our view, such a context pushes the government to aim for a steady increase of supply of units instead of trying to crush demand.


Richard Yue, Arch Capital Management Co

What are your short- and/or long-term outlooks for Hong Kong's property market for institutional investors interested in the city-state?

Yue: Hong Kong is one of Asia's most important real estate markets. The soaring property prices are mainly due to the lack of new land supplies. There is a huge mismatch in terms of where new land supply is and where the largest demand is, as clearly demonstrated by recent land transactions. The lack of new supplies will mean strong support for the real estate market in Hong Kong. However, the high prices and additional tax for foreign investors will — in the mid- to long run — discourage international companies from doing business or investing in Hong Kong.

Flageole: In the short run, we would be more prudent on residential prices, given the renewed commitment of authorities to try to manage the rapid appreciation over the last year. In addition, from an investment standpoint, with land sites selling for higher prices, there is a potential reduction of development margins and yields.

Over the long term, we remain positive on Hong Kong property as a whole, given our thinking that the city-state would remain a desirable hub for market participants in the Asia Pacific region, particularly for mainland Chinese firms expanding gradually outside of their home base.

With Hong Kong being very land constrained, existing assets have high replacement costs and should, over the long run, maintain their value. A number of real estate investors in Hong Kong might have a longer-term investment horizon than typically seen with real estate funds in Europe or North America. The longer horizon might mean investors are willing to accept a higher initial price for their purchase, thinking that they will hold the asset for several decades. This mentality might mean real estate prices could stay elevated with relatively few transactions.

Moore: Hong Kong's real estate market has matured in many ways in the 20 years since the handover, and it is certainly attracting more international institutional attention. Provided Hong Kong retains its status as an international business centre and interconnects positively with the mainland, its future will be very bright.

Investors should understand that, in the short term, Hong Kong will continue to be an expensive, volatile market with relatively-large price movements. ❖