

Adaptive Spaces

Flight to Quality in the Asia Pacific Office Market

REPORT

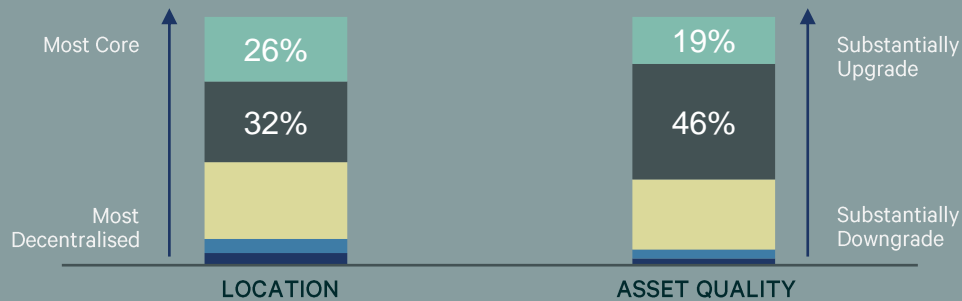
CBRE RESEARCH
JUNE 2024



Flight to Quality in the Asia Pacific Office Market

1 Relocations Focus on Quality Offices

Office occupiers prefer to upgrade their office space in core locations when relocating



2 Top Five Reasons to Drive Flight to Quality

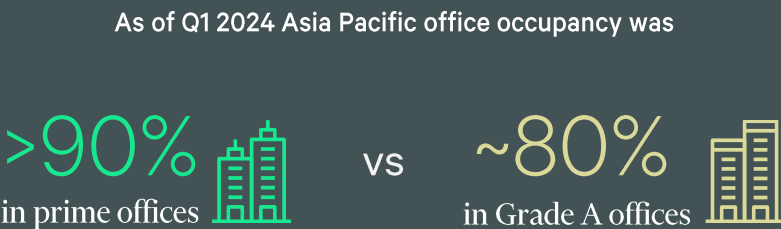
- #1 Employee preference for core locations
- #2 Need for workplace transformation
- #3 Demand for green buildings
- #4 Improving office availability
- #5 Tenant-favoured market

3 Flight to Quality in Asia Pacific

	 Building Upgrade	 Flight to core	 Flight to green
Australia	•	•	•
Hong Kong SAR	•		•
India	•		•
Japan	•	•	
Korea	•		
Mainland China	•		
Singapore		•	•

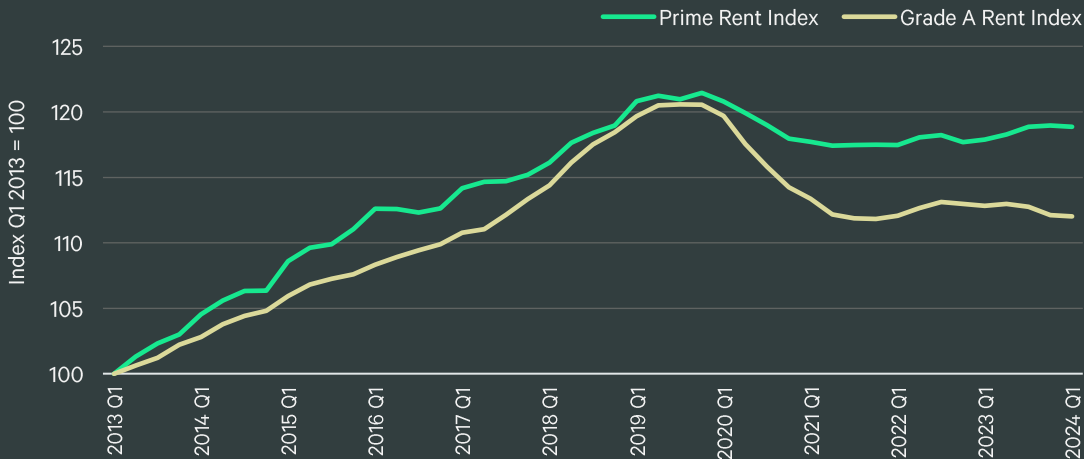
4 Impact on Occupancy

Prime offices* enjoy a much higher occupancy rate than general Grade A offices



5 Impact on Rents

Rental performance of prime offices is more resilient than general Grade A offices



*Prime office is the top tier portion of the Grade A office market which demonstrates the highest quality and building specifications in the best location of a market. It generally represents less than 10% of Grade A office stock in Asia. In Pacific markets, prime offices include only premium grade offices in regional context.
Source: CBRE Research, June 2024.

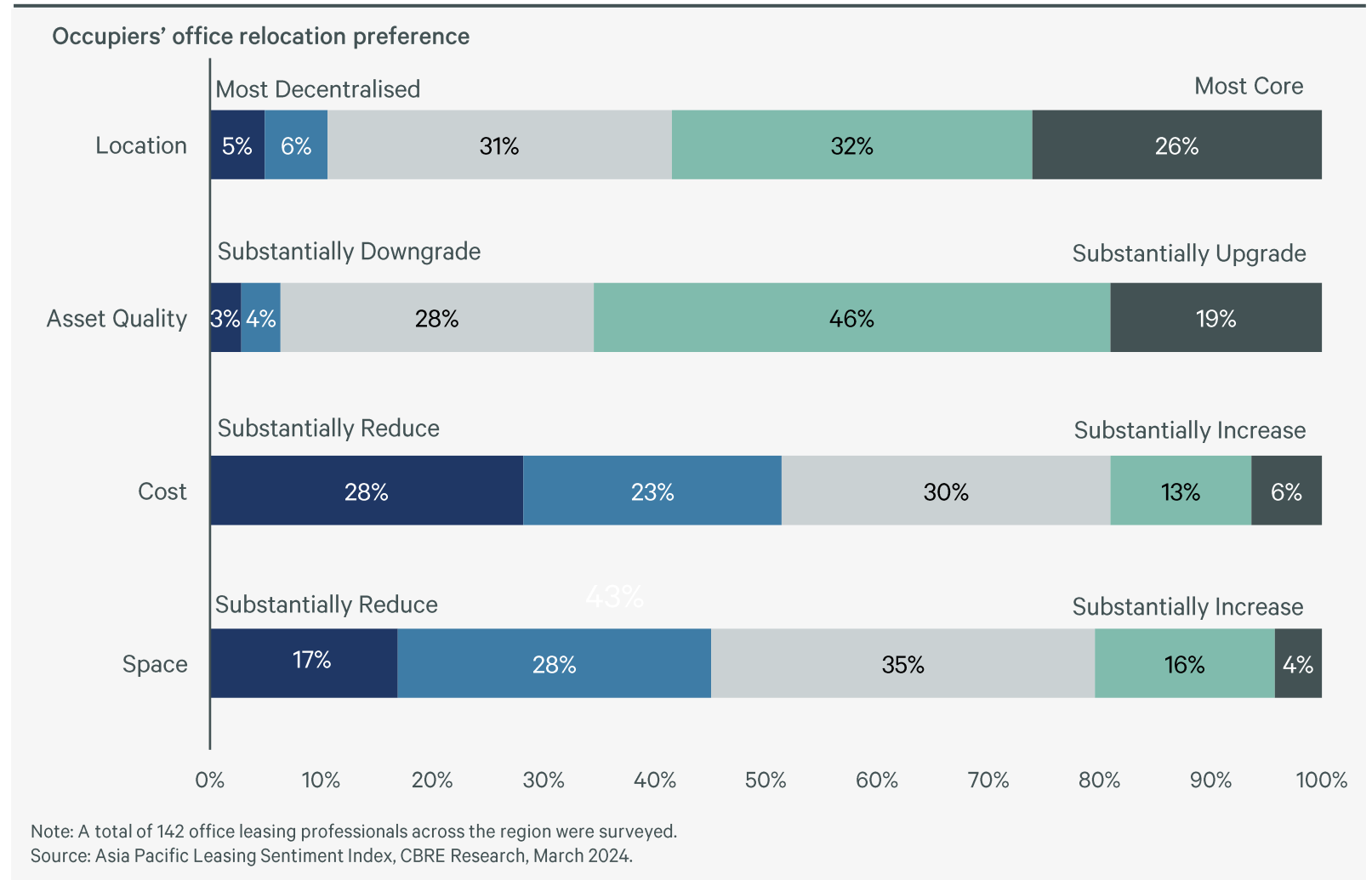
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01

Flight to quality trends in Asia Pacific

Relocation focuses on quality offices

- Office occupiers in Asia Pacific generally remain cost cautious amid slower economic growth; the high interest environment; and elevated fit-out costs. Leasing activity over the past two years has therefore been dominated by renewals as companies seek to avoid incurring extra CapEx upon lease expiry.
- CBRE's latest Asia Pacific Leasing Sentiment Index shows that more occupiers are conducting "stay vs go" studies to evaluate options, with almost one-fifth of leasing enquiries related to this analysis. Having decided to relocate, occupiers prioritise space quality over size. Occupiers usually seek more core office locations and better quality of space while capitalising on the opportunity to save costs.
- Relocations invariably involve some consolidation or downsizing, with some selected cases of same size relocation or expansion observed over the past two years. A flight to quality trend is playing out in many Asia Pacific office markets, regardless of how office size changes after relocation.
- While occupiers in Japan, Singapore and Australia are displaying the strongest demand for core office locations, the preference for higher quality office space is widespread across the entire Asia Pacific region.



Analysis of flight to quality patterns

- Flight to quality related to asset quality generally refers to occupiers trading up to a higher quality office space or moving from a non-green building to a green certified building.
- CBRE's analysis of leasing deals involving relocations in Beijing, Hong Kong SAR and Taipei in 2023 found that over 60% involved upgrading. Numerous cases were recorded of occupiers flocking to quality space from business parks and Grade B/C buildings to newly completed or existing Grade A offices. In Tokyo, Grade A- buildings saw an exodus of tenants to newly completed Grade A offices.
- Another form of asset quality upgrading is “flight to green” in markets where the green building adoption rate is high, such as Australia and Singapore. Green buildings also account for an increasing share of new leases in markets where green building adoption is still nascent. Approximately 60% of new Grade A office leases signed in Greater China and India in 2023 involved green buildings.
- Flight to core is the term used to describe relocations to prime areas. Prime office buildings¹ with state-of-the-art facilities are typically built in core locations, amplifying occupiers' desire for flight to core.
- Among mature markets, most leasing transactions in Japan, Singapore and Australia were completed in locations that can offer easy access to public transport and reduce commuting times for employees.
- While it is common to see flight-to-quality within core locations, decentralised areas in Greater China and India retain substantial appeal, with the bulk of new offices with high quality facilities and amenities being constructed in these locations.

1: Prime office is the top tier portion of the Grade A office market which demonstrates the highest quality and building specifications in the best location of a market. It generally represents less than 10% of Grade A office stock in Asia. In Pacific markets, prime offices include only premium grade offices in regional context.



Flight to quality patterns vary across the region

Mainland China

- Ample high-quality new supply, mostly in emerging areas, is providing flight to quality options
- Occupiers are leveraging the downward rental cycle to upgrade their offices without cost escalation

India

- Ample high-quality new supply in decentralised submarkets with improving infrastructure is providing flight to quality options
- The presence of multinationals and more green certified space in newly completed buildings is driving flight to green relocation

Australia

- High incentives and lower than pre-pandemic CBD rents in some markets is incentivising flight to core
- Driving the return to office via workplace transformation and locating in amenity rich districts is creating the need for building upgrades
- Green building adoption is high, with companies following minimum green standards for office space set by the government

Korea

- Workplace transformation to attract and retain talent in some expanding industries is creating the need for building upgrades
- High-quality space demand is also due to forced relocation from headquarters building disposal or redevelopment

Japan

- Intense competition for talent and ongoing workplace transformation is creating a need for building or locational upgrades
- The ongoing delivery of a large volume of high-quality new supply in core locations is providing opportunities for location upgrading

Hong Kong SAR

- Occupiers are leveraging the downward rental cycle to upgrade buildings without cost escalation
- More new and high-quality office buildings with green features are coming to market

Singapore

- Employees have a strong preference to work in the CBD due to better connectivity and shorter commuting times
- Green building adoption is high due to government initiatives, with abundant options facilitating flight to green activity



Building Upgrade



Flight to core



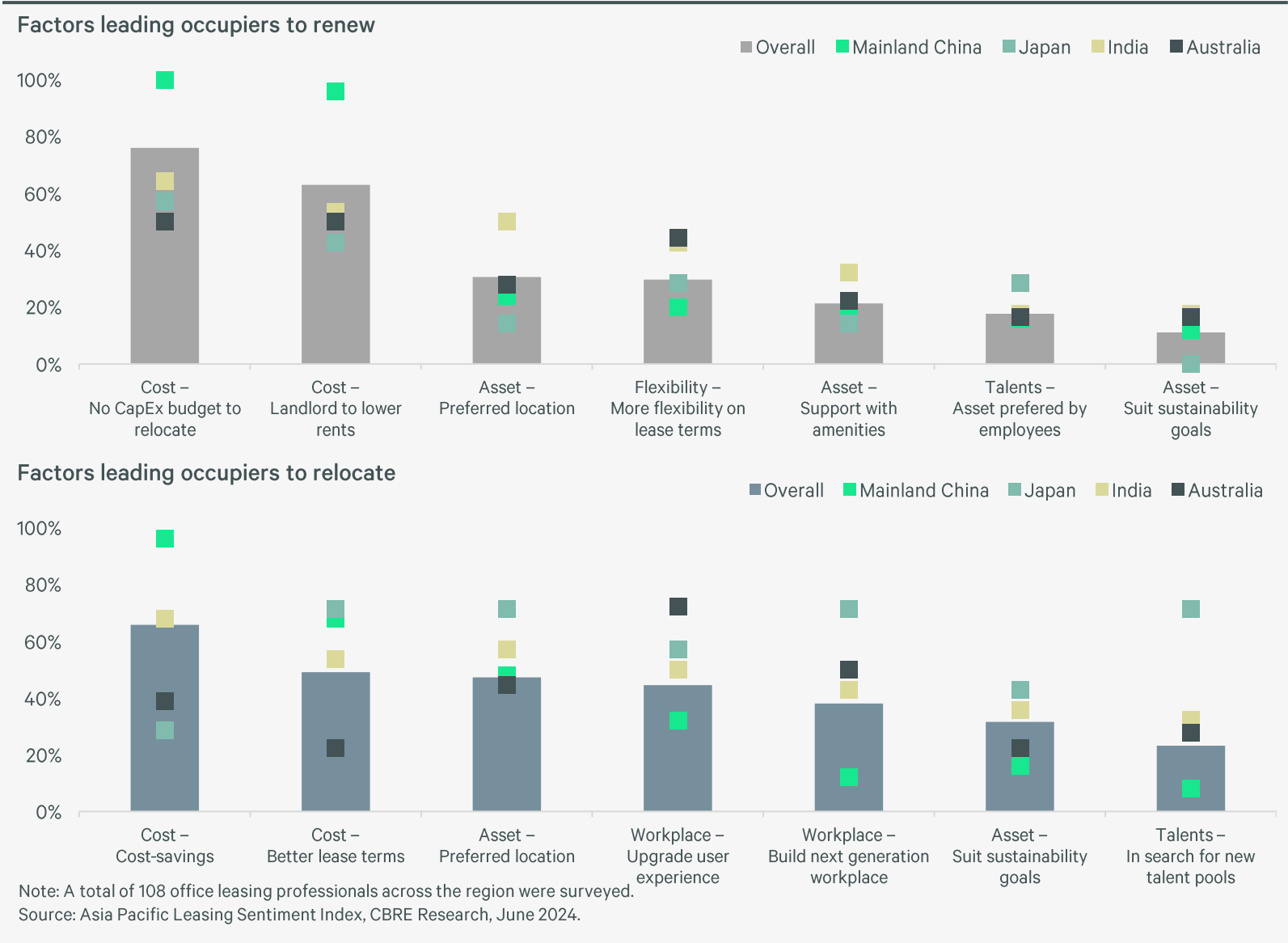
Flight to green

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Drivers of flight to quality

Evaluating “Stay vs Go” decisions

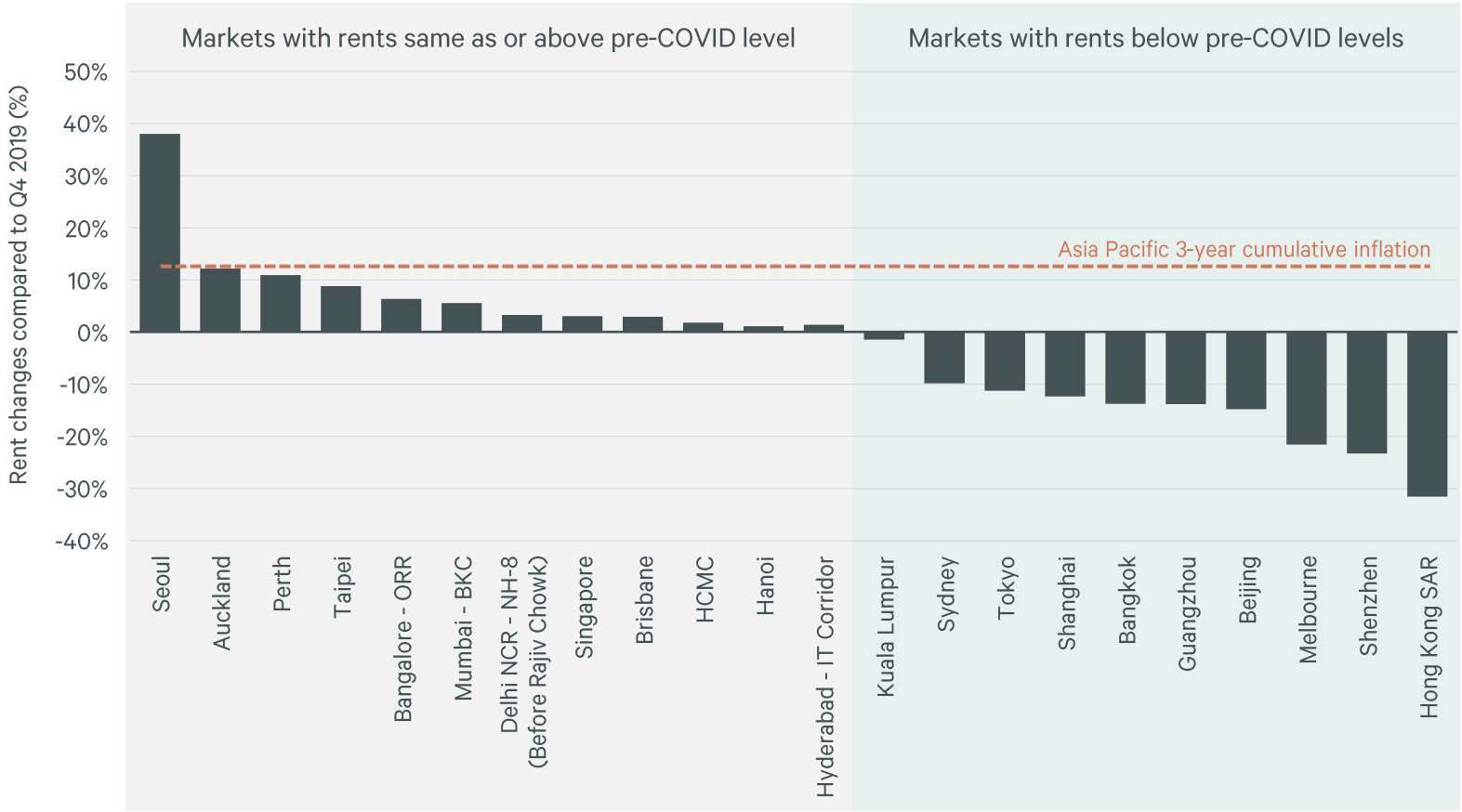
- While cost is a key determining factor in renewal or relocation decisions, other considerations are at play for the latter.
- Over 60% of companies choosing to renew leases did so either because they had no CapEx budget or because landlords offer lower rents; issues that ranked particularly highly among occupiers in mainland China. While asset quality, location and surrounding amenities play a relatively small role in renewal decisions, their influence varies by market. In India, staying in a preferred and amenity rich location was ranked relatively highly by occupiers opting to renew, while in Australia, flexibility of lease term was cited as an important factor.
- While relocations by occupiers in mainland China were predominately cost driven, drivers in other major markets were a combination of cost, asset quality and location, workplace and talent considerations. Occupiers, especially those in Japan and Australia, are not only focusing on cost saving opportunities and securing more attractive lease terms, but also on how a new office could facilitate workplace transformation and enhance employee experience to attract and retain talent. All these factors are influencing building selection criteria and boosting demand for flight to quality.



Cost: Tenant-favoured market

- Recent years have seen landlords in most Asia Pacific office markets become more accommodative towards rental negotiations. Rents in around half of markets are still below pre-pandemic levels, with those in Greater China, Tokyo, Sydney and Melbourne lagging the furthest.
- Occupiers in these markets have been able to capitalise on lower rents to complete flight-to-quality moves. This trend has been especially prominent in tier I cities of mainland China and Hong Kong SAR, where Grade A rents have fallen by 30-40%. In India, occupiers can also consider building upgrades in emerging submarkets due to relatively higher availability of high quality assets.
- Incentives in Sydney and Melbourne remain high at 30-50% despite rents displaying growth over the past two years. High incentives continue to underpin flight-to-quality and relocations to prime assets.
- While most markets registering rental growth are still lagging the inflation rate, occupiers in Seoul may find it challenging to justify flight to quality moves as rents are significantly higher than pre-COVID levels and availability is limited.

Grade A effective rental change compared to pre-COVID levels



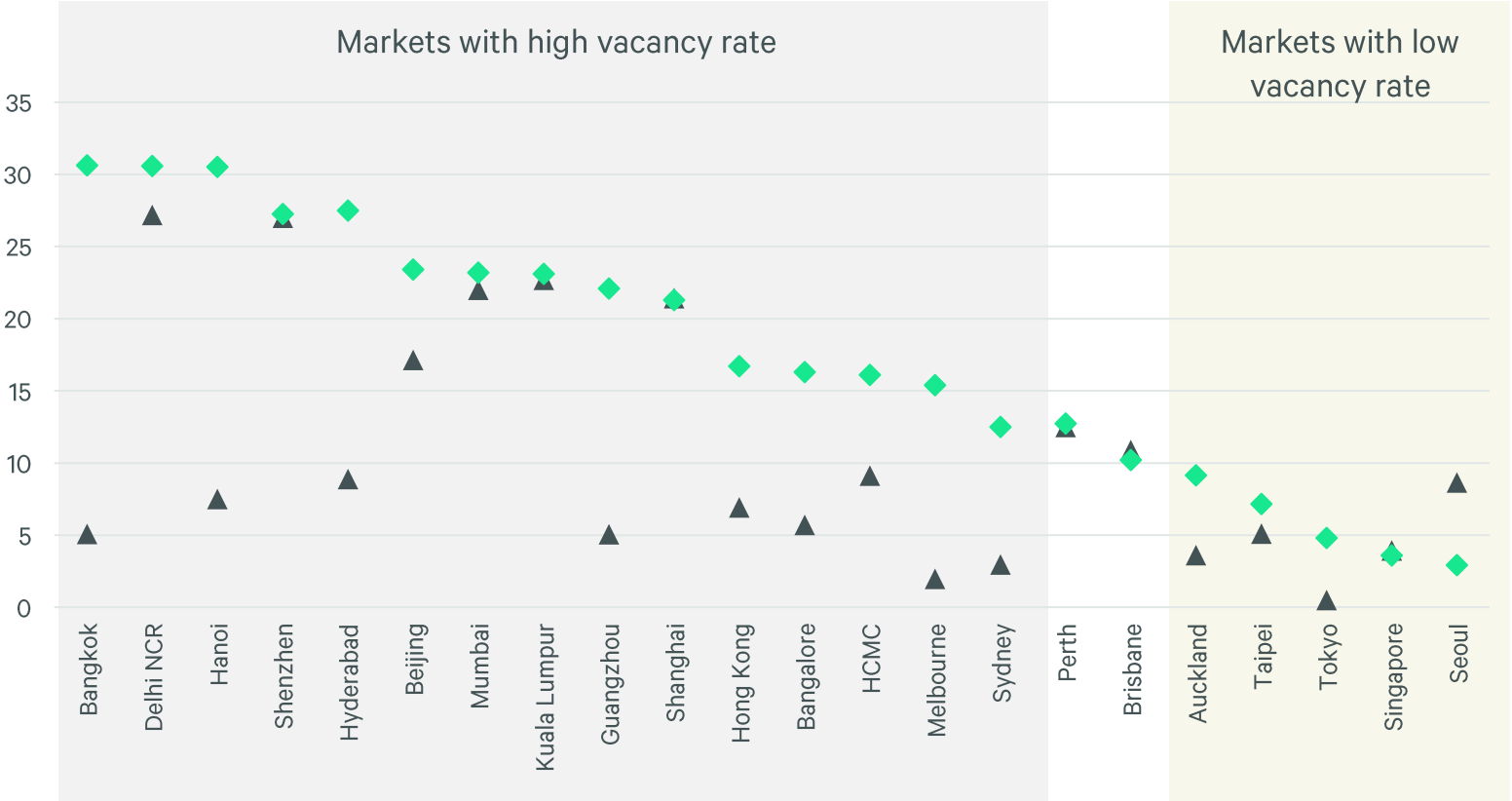
Note: Grade A rents represent rents in CBD /specified core locations. The change in rents compares Grade A rents from Q4 2019 to Q4 2023.
Source: CBRE Research, June 2024.

Asset: Improving office availability

- The rise in office availability in most Asia Pacific markets, both from new supply and existing vacant space, has been facilitating the flight to quality trend over the past five years.
- The most significant jump in vacancy between 2019 and Q1 2024 was recorded in mainland China and selected Southeast Asian markets including Bangkok due to large new supply. Markets in India along with Melbourne have also seen vacancy stay at high levels. Occupiers have abundant high quality options to choose from in these oversupplied markets.
- Except for Seoul, availability in tightly held office markets across the region has also improved over the past five years. While limited availability may restrict large size relocations, flight to quality to small-sized spaces remains feasible. In some cases, large occupiers have been able to reduce their footprint while upgrading to smaller but higher quality spaces.

Change in overall Grade A vacancy rate between 2019 and Q1 2024 (%)

▲ Q4 2019 ◆ Q1 2024

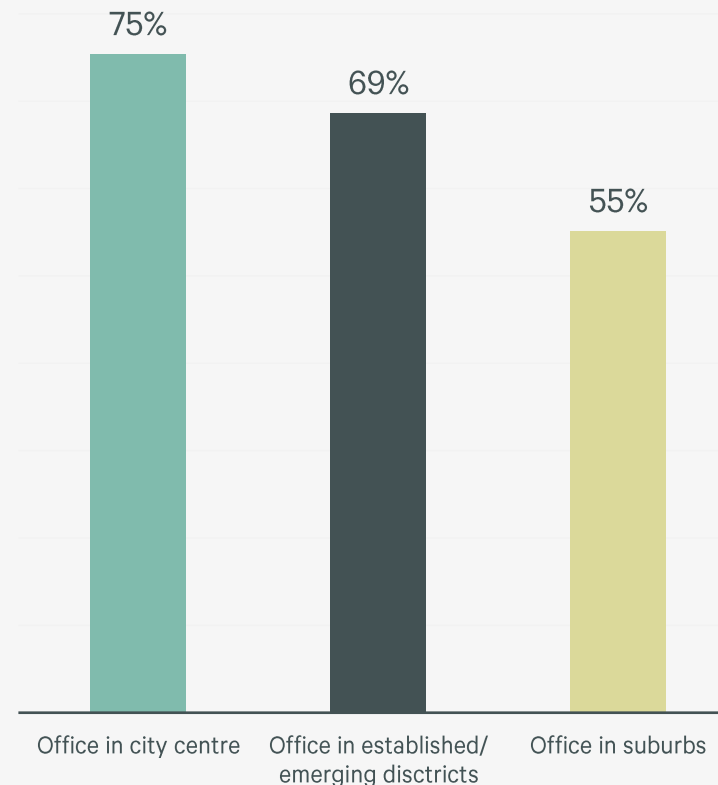


Note: Pacific markets report vacancy rate bi-annually. The Q4 2023 total vacancy rate was used.
Source: CBRE Research, June 2024.

Asset & Workplace: Occupiers' evolving demands

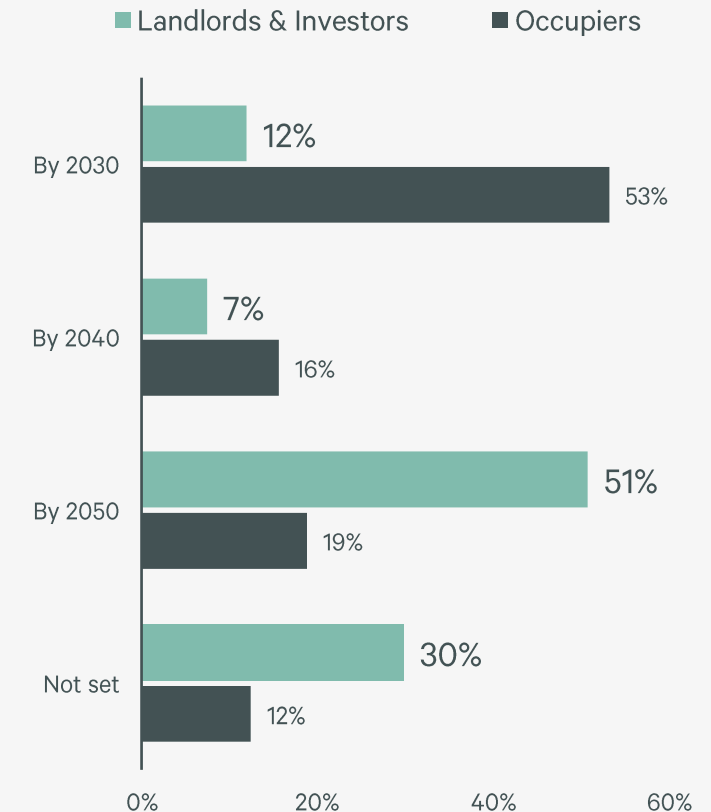
- Although the return to office ratio in Asia Pacific is the highest globally, new ways of working spurred by the pandemic are here to stay. As occupiers seek to attract and retain top talent, they must review portfolio locations and consider workplace transformation.
- CBRE's 2022 Asia Pacific Live-Work-Shop Survey found that 75% of office workers in Asia Pacific prefer offices in city centres or in established/emerging districts with good transport connectivity and high-quality surrounding amenities.
- Large and efficient floorplates are crucial to workplace transformation. Modern workplaces should foster flexibility, collaboration, productivity and wellbeing of employees. As a result, Grade A offices in city centres or in major business districts are and will continue to be highly sought after.
- Building selection is increasingly influenced by companies' ESG aspirations. While half of multinationals aim to achieve net zero by 2030, green building adoption in Asia Pacific was just 46% at the end of 2023. Adoption was higher in Australia, Singapore and Japan where could facilitate flight to green activity .

Office satisfaction by location, Asia Pacific



Source: 2022 Asia Pacific Live-Work-Shop Survey, CBRE Research, December 2022

Has your organisation set a net zero target?



Source: APAC CSO Survey, February 2024.

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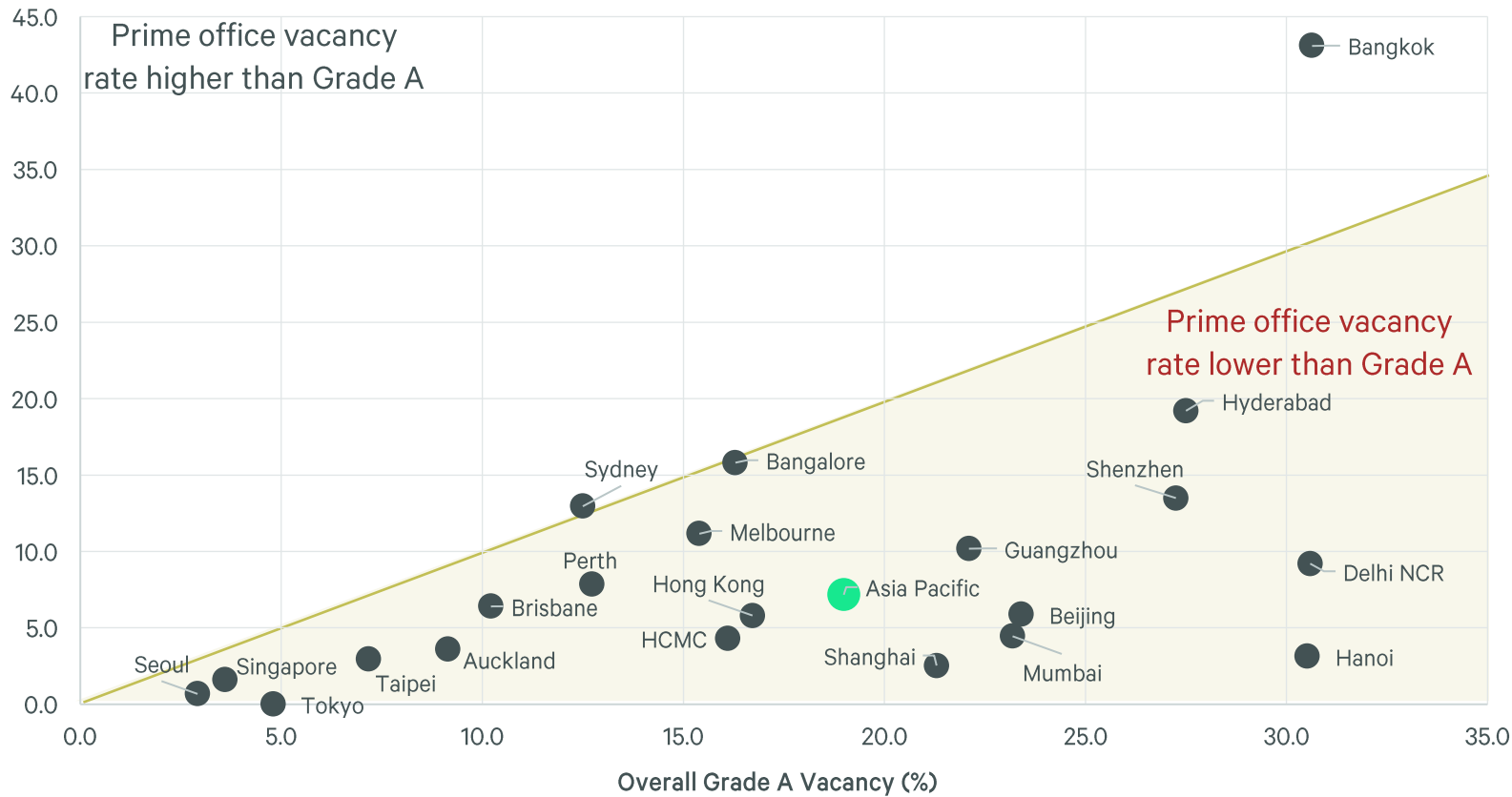
Impact on rents and occupancy

Prime offices have higher occupancy

- CBRE’s analysis of the Q1 2024 vacancy rate for prime office buildings and general Grade A office buildings in Asia Pacific found that prime offices have higher occupancy than the market average in most markets. This is because occupier demand has shifted to the top tier of the office market in recent years. Average regional vacancy for prime assets was about 7% as of Q1 2024, well below the 19% for general Grade A offices.
- While most of mainland China and India markets register more than 20% general Grade A vacancy, that for prime buildings can be as much as 100-250bps lower than the average. This reflects the low availability of prime buildings and the fact that such properties possess features that cater to occupiers’ requirements and therefore outperform the rest of the market. In tightly held markets such as Seoul and Singapore, the difference in occupancy is minimal as occupiers have limited choice and are forced to lease any space that becomes available.
- In some cases, the vacancy rate of prime buildings may be temporarily higher because they are newly built prime properties that are still leasing up or not located in the most sought-after submarkets.

Asia Pacific prime vacancy rate vs Grade A vacancy rate (Q1 2024)

Prime Vacancy (%)

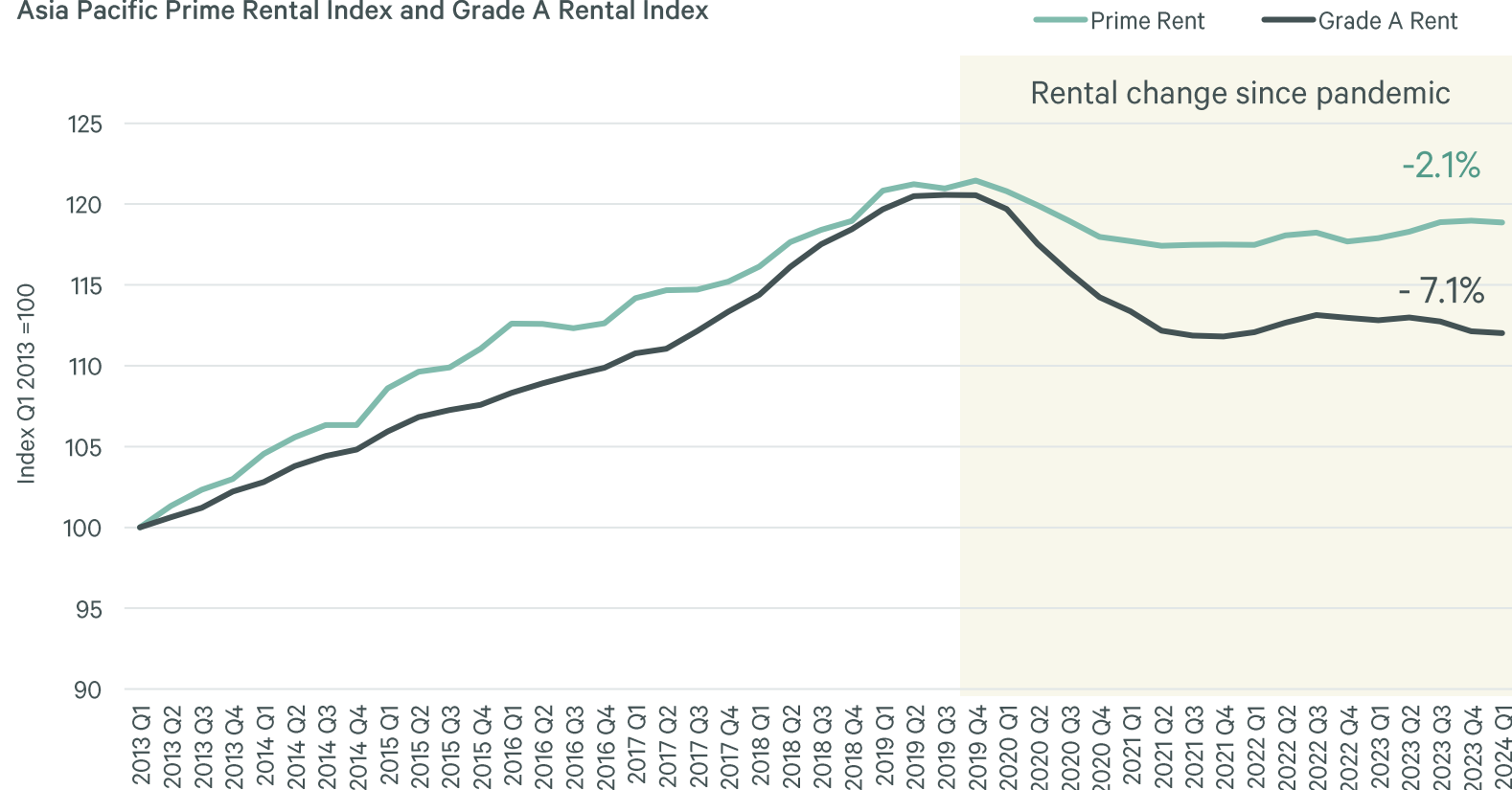


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Widening gap between Prime and Grade A rental indexes

- CBRE's Asia Pacific Prime Rental Index and Grade A Rental Index show that prime office rents have been more resilient since the rental downward cycle commenced in 2020. While both indexes have recorded a decline since Q4 2019, the Prime Rental Index has fallen by 2.1% while the Grade A Rental Index has dropped by 7.1%.
- The gap between the two Indices has widened recently, especially since the beginning of 2023 when the Prime Rental Index started to rebound while the Grade A rental Index was still declining.
- Landlords of prime offices are less exposed to vacancy pressure as they are beneficiaries of flight to quality demand. This enabled them to adopt a firm stance towards rental negotiations during the downcycle and provided them with the confidence to raise rents when the market started to recover from the pandemic in 2022/23. In contrast, landlords with less competitive Grade A portfolios were forced to stay accommodative to fill space.

Asia Pacific Prime Rental Index and Grade A Rental Index

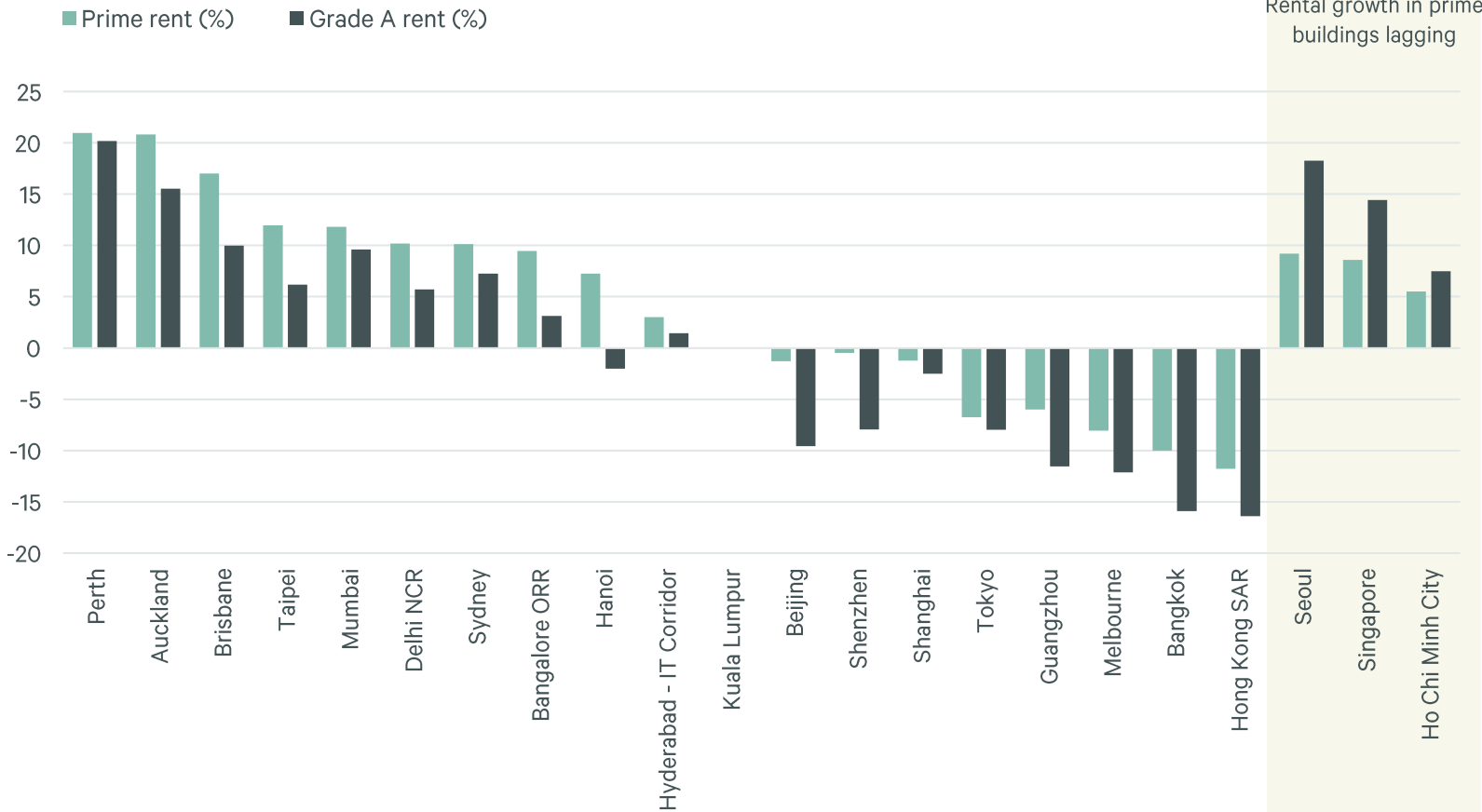


Note: The same weighting of office stock in 25 Asia Pacific markets is used to calculate both the Prime Rental Index and Grade A Rental Index.
Source: CBRE Research, June 2024

Rents for prime buildings outperform

- Given the uneven recovery of the Prime Rental Index and Grade A Rental Index, cumulative rental growth over the past three years for prime properties in Asia Pacific has outpaced that for Grade A assets in most growth and laggard markets.
- The two-speed rental trend has been most prominent in Brisbane, Auckland, Taipei, Delhi NCR, Bangalore, Beijing and Shenzhen. This indicates that the imbalance of supply and demand for prime assets is significant in these markets.
- Selected markets including Singapore and Seoul have seen cumulative rental growth for prime assets lag the market average. This is likely due to a higher base effect (i.e. high rent) and limited product differentiation between prime and general Grade A offices.

Prime rent and Grade A rent three-year cumulative growth (2021 – 2023)



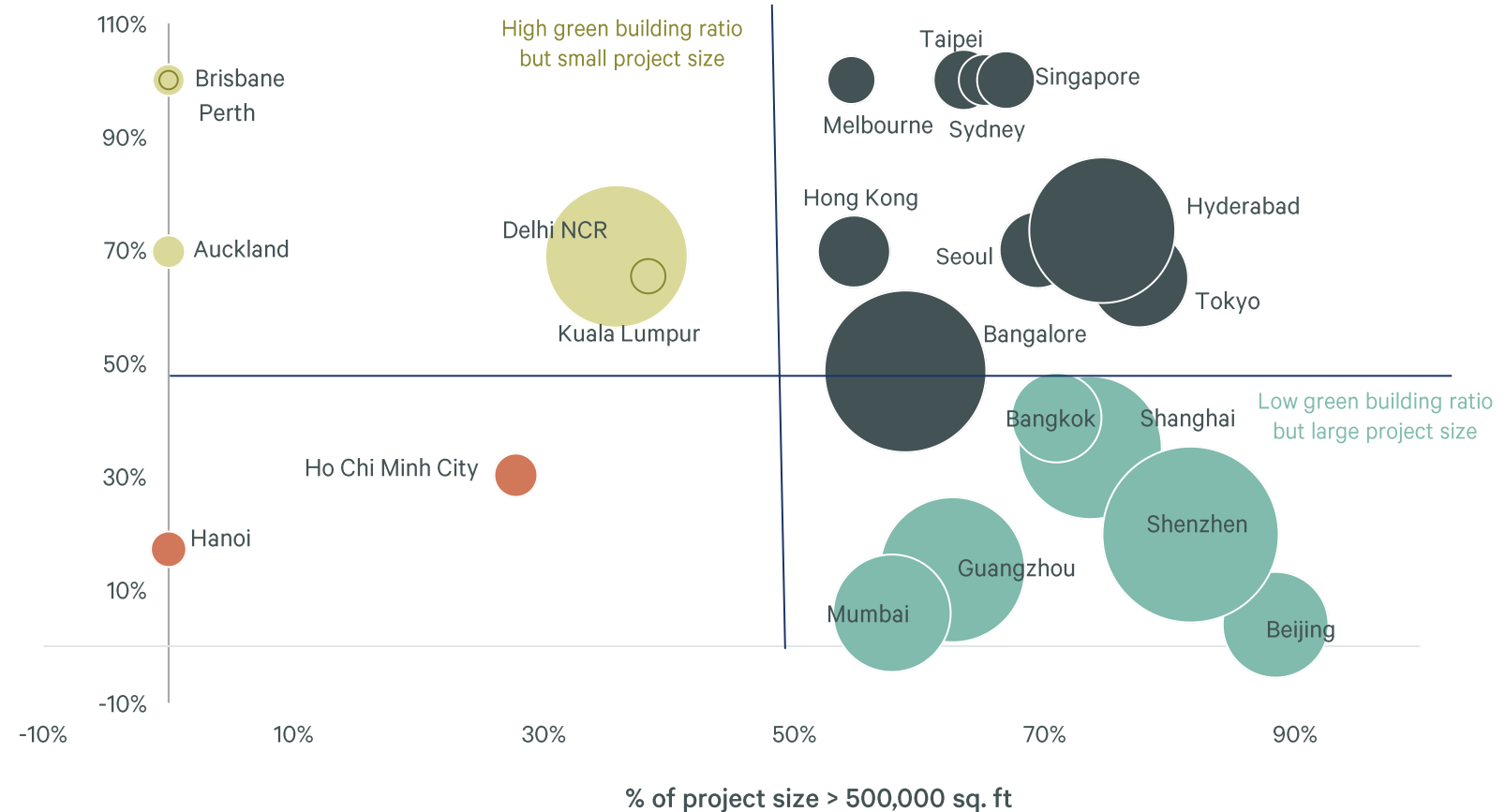
Source: CBRE Research, June 2024.

Prime offices will remain competitive

- Asia Pacific remains in the midst of a supply boom, with over 60 million sq. ft. NFA of new stock scheduled to be delivered in each of the next three years. Most new stock will be built in Grade A standard.
- India and mainland China account for over 75% of new supply but around two-thirds of projects are located outside core areas. As a result, stock of prime buildings with green certification, large floorplates and in core locations will remain limited. In mainland China, the low green building adoption rate will ensure existing and future prime buildings with such features continue to command a rental premium. While buildings offering larger floor-plates will enjoy an advantage in the Indian marketplace, existing and future prime buildings located within integrated tech parks with features such as green certification, better infrastructure and amenities will commend higher rents.
- Although upcoming new supply in Hong Kong SAR, Taipei, Singapore and Australia is relatively moderate, these markets will see a rise in inventory of prime space. Growing competition may limit significant rental growth for prime office buildings.
- Medium-term new supply in the region is likely to moderate from the current peak due to high financing and construction costs. Redevelopment of aging office stock is also unlikely as it is costly to implement at the moment. The volume of newly built assets suited to occupier requirements thus will fall, ensuring prime assets stay competitive.

Asia Pacific new office supply under construction (2024-2027)

Estimated % of green buildings



Note: The size of the bubbles represents the total size of new supply under construction (2024-2027).

The estimated percentage of green buildings and percentage of project size is based on total size of new supply under construction in each respective market.

The estimated percentage of green buildings in Tokyo and Seoul is assumed by the total size (>1 million sq. ft.) and/or grade of new projects.

The actual percentage of green buildings is likely to be higher than estimate in most markets given most assets to be completed in 2027 are currently at the planning stage and tracking green-certification is challenging.

Source: CBRE Research, June 2024.

04

Implications for occupiers and landlords

Conclusion



Recommended Occupier Strategies

Periodically Review Office Portfolios

- Evaluate the cost and benefits of flight to quality moves by reviewing the location, building quality and amenities of office portfolios against employee preference to ensure space remains competitive and can facilitate talent attraction and retention.

Pursue Workplace Transformation

- Transform to high performance workplaces or reconfigure offices to foster collaboration among employees. Adopt flexible workspaces featuring wellness and sustainability aided by new technology to support new ways of working.

Perfect Market Timing

- Understand market timing and how flight to quality moves could impact rents and demand for high quality space in certain areas. Engage in flight to core or building upgrades when a market still favours tenants or rents are still below pre-pandemic levels.

Adopt a Proactive Approach to Pre-leasing

- Understand the existing and future competitive landscape of prime office markets, which are always tightly occupied. Adopt a proactive approach towards pre-leasing space in strategically located assets and high-quality new builds.



Recommended Landlord Strategies

Selectively Commit to New Projects

- Carefully consider new development projects in light of the polarisation of rental performance, occupancy and tenant quality between prime and non-prime office buildings. Adopt a holistic and innovative approach towards designing futureproof buildings suited to tenants' requirements.

Invest in ESG

- Invest in or develop office buildings with ESG features to align with tenants' net zero targets.

Consider Asset Enhancement Initiatives

- Pursue asset enhancement initiatives to upgrade features such as flex space, wellness amenities, ventilation, technology (e.g. internet infrastructure, smart lifts and touchless technology) and car parking.

Prioritise Occupancy in Aged Office Portfolios

- For those landlords with older office portfolios, prioritise occupancy rather than rents by offering attractive terms to secure tenants, especially in oversupplied markets.

Consider Asset Conversion

- For those landlords with older properties in less desirable locations, consider office conversion to other usage such as residential, senior or student housing.

Contacts

Research

Henry Chin, Ph.D.

Global Head of Investor Thought Leadership
Head of Research, Asia Pacific
henry.chin@cbre.com.hk

Ada Choi, CFA

Head of Occupier Research, Asia Pacific
Head of Data Intelligence and Management, APAC
ada.choi@cbre.com.hk

Cynthia Chan

Senior Director, Asia Pacific
cynthia.chan@cbre.com.hk

Advisory & Transaction Services

Luke Moffat

Regional Managing Director
Head of Advisory & Transactions Services
Asia Pacific
luke.moffat@cbre.com

Hugh Hamilton

Managing Director
Head of Accounts, Asia Pacific
hugh.hamilton@cbre.com

Richard Stevenson

Managing Director
Head of Office Occupier
Asia Pacific
richard.stevenson@cbre.com

Rohini Saluja

Managing Director
Head of Advisory & Consulting
Asia Pacific
rohini.saluja@cbre.com

Sidharth Dhawan

Executive Director
Head of Alternatives, Asia Pacific
sidharth.dhawan@cbre.com

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