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Solution for office overhang?

Bring in the MNCs to solve problem → COVER STORY PAGES 2-4, 8

Office overhang - solution in sight?

IMBALANCE: With an additional 26 million sq ft expected in the next five years, many are predicting Klang Valley's office market to slow down unless we can make it attractive enough as a regional hub for MNCs

KHAIRUL KHALID

In Klang Valley's residential housing market, the general consensus currently is that demand is far outstripping supply, causing prices to reach record levels in the past few years. In the Klang Valley office market, quite the opposite is happening. Supply of new office buildings is pouring into the market, prompting concerns of a market overhang, a situation whereby excess supply will eventually dampen prices.

As at 1Q 2013, there is a total of 104 million sq ft office space in the Klang Valley based on the statistics published in the NAPIC (National Property Information Centre) Commercial Stock report. The overall vacancy rate in the market is reported at 23 per cent, slightly lower than the 25 per cent vacancy rate recorded in the previous quarter.

The overall vacancy rate for selected Grade A buildings in Klang Valley (or Greater KL) market stood at 18 per cent during 2Q13 compared to 20 per cent recorded in 1Q13, based on a sample basket of Grade A buildings tracked by YY Property Solutions. Average gross asking rent in the Greater KL market for Grade A buildings remains stable at RM6.83 psf during 2Q13 (1Q13: RM6.87 psf), reflecting overall stable demand for office space in the market.

Although the market looks stable for now, what does the future hold for the office market in Klang Valley? According to Sr James KM Tan, Associate Director of Raine & Horne, there are too many offices coming up in the Klang Valley in the next five years and he expects a glut in the next decade. Do others share Tan's sentiments? **NST RED** speaks to other industry players to get their views on the situation.

Y Y LAU, Director of YY Property Solutions Sdn Bhd (YYPS)

The word "oversupply" has been frequently used recently to describe the Klang Valley office market, which has its own merit by looking at the total existing stock of 104 million sq ft when calculating private-owned office buildings located in Kuala Lumpur, Selangor and Putrajaya.

By analysing further, there is no doubt that market segmentation, product differentiation strategy and pricing strategy have helped several office building developers to secure reputable and growing organisations to take up space at their buildings. Examples are Swift and Pfizer taking up space at Bangsar South development.

Nevertheless, the overall supply scenario in the KL CBD (Central Business District) and KL Fringe market does put pressure on both the newly completed buildings and existing buildings in these sub-markets, as the pace and the quantum of demand has to catch up rapidly with the large amount of new office space in the market – almost 2.8 million sq ft in KL CBD in year 2012 alone, and an estimated of 4 million sq ft in KL Fringe by end-2013/early-2014. As a benchmark, the total net absorption in the Klang Valley office market was approximately 2 million sq ft in FY2012, based on Napic statistics.

YYPS categorises Klang Valley office market into four prime areas, namely KL CBD, KL Fringe, Decentralised Area and Cyberjaya & Putrajaya. The 2Q 2013 market overview of the Grade A office property market in the four prime areas are described below:

KL CBD

As at 2Q 2013, average vacancy rate in KL CBD stood at 21 per cent compared to 26 per cent recorded in 1Q 2013. The lower vacancy rate is mainly due to the higher occupancy rates achieved by a handful of new buildings completed in the second half of 2012, as well as stable occupancy rates achieved by existing buildings included in their sample basket for monitoring good grade buildings in this submarket. As of now, there are still quite a number of buildings completed in year 2012 not achieving significant occupancy rates. Average gross asking rent for the monitored buildings remained stable at RM8.41 psf during 2Q 2013 compared to RM8.46 psf recorded in 1Q 2013.

KL Fringe

During 2Q 2013, existing Grade A buildings in our sample basket for this submarket experienced improved occupancy rates, which helped to offset the high vacancy rates observed in the newly completed buildings in KL Sentral. Overall average vacancy rate in this submarket lowered to 17 per cent during 2Q 2013 from 19 per cent recorded in 1Q 2013. Average gross asking rent in this submarket edged up slightly to RM6.66 psf compared to RM6.50psf in 1Q 2013.

Decentralised Area

Demand for Grade A office buildings in the Decentralised Area remained strong during 2Q 2013 as there is lack of new supply of Grade A buildings in this submarket. Existing Grade A buildings in this location continued to enjoy high occupancy rates due to the limited supply of such good quality buildings.

Average vacancy rate in this submarket increased to 12 per cent in 2Q 2013 from 5 per cent recorded in 1Q 2013, mainly because tenants of the newly completed building Plaza 33, Petaling Jaya (extension of Jaya 33) Tower A & B have yet to move in to these buildings.

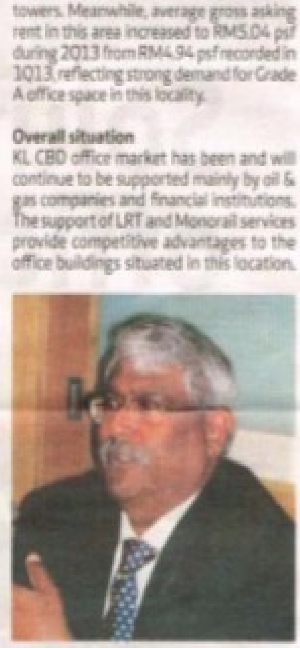
Vacancy rate in this submarket is expected to reduce over the next six months when these tenants move to the two towers. Meanwhile, average gross asking rent in this area increased to RM5.04 psf during 2Q13 from RM4.94 psf recorded in 1Q13, reflecting strong demand for Grade A office space in this locality.

Overall situation

KL CBD office market has been and will continue to be supported mainly by oil & gas companies and financial institutions. The support of LRT and Monorail services provide competitive advantages to the office buildings situated in this location.

*Lau... "**Developers may need to strategise their pricing** to face the large incoming supply."*

*LK Tan... "**More consultancies and professional services companies prefer suburban locations** due to lower rents and better transportation links."*



*Mani... "**Traffic congestion in central KL** could force tenants to move out to the fringes of the city centre."*

Likewise, the successful integrated development concept adopted by KL Sentral, Mid Valley City and Bangsar South in KL Fringe locations will continue to attract corporates to set up offices at these developments.

Nevertheless, given the large incoming supply of office space expected over the next five years (estimated supply of 16 million sq ft in KL CBD and 10 million sq ft in KL Fringe), the ability to create new demand is crucial to support the office market in these locations in the future.

Overall, developers may need to strategise their pricing in order to face the challenges arising from the large incoming supply in the near future. Developers which have yet to start construction for their proposed office buildings will need to monitor the market closely and consider putting on hold their project if need be.

Owners of relatively aged existing buildings will face the issue of either undertaking extensive refurbishments/upgrading on their buildings or offering lower rents and/or attractive lease terms to its existing tenants in order to retain these tenants while at the same time continuing to offer good quality property management services to their tenants.

Datuk Mani Usilappan (Former Valuation and Property Services Department Director-General)

In the KLCC (Kuala Lumpur City Centre) area, occupancy rate is well under control with average occupancy rate of 82 - 83 per cent, which is fairly normal and consistent. There are not many pieces of land left in KLCC area for office development. Therefore, prime office space does not face an oversupply problem. A few years ago, rentals shot up to RM8.50 - RM10 psf but a lot of people didn't know that a lot of owners were giving 2-3 months of rebate.

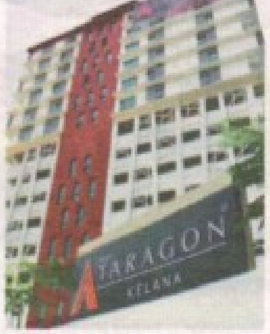
I feel the biggest problem is the traffic congestion in central KL area which if not managed well will force tenants to move out to the fringes of city centre such as Bangsar and Damansara Heights that are seeing a lot of new integrated developments including offices. In fact, it is already happening now.

Under construction offices in Malaysia is about 20 million sq ft (Q1 2013 NAPIC). Completed units are about 1.5 - 3 million sq ft which is a reasonable take-up rate especially from tenants moving from old to new buildings. The question is what happens to the old offices in old buildings? You may see a lot of refurbishment taking place at these buildings as well. If you look at the under-construction figures, of course, you will see an overhang but I think the occupancy rate can adjust itself over time.

K.H. Sim, Chairman of Allstones Group Asia Sdn Bhd

The market could move towards an overhang when projects such as TRX and Warisan Merdeka starts and nears completion. With these, there will be added supply which will saturate the existing market. At present, supply is definitely increasing faster than demand which has led to an oversupply situation.

There are several key drivers of growth in the market including economic growth and investments in Kuala Lumpur and Malaysia. For example, the rise of the services industry that in turn leads to higher demand. Improved transparency and corporate governance is also vital in making Malaysia an attractive location as a regional hub. The extension of the LRT and completion of MRT lines and other infrastructural improvement within the Klang Valley will also spur growth.



Plaza Taragon Kelana.

Based on our experience developing Plaza Taragon Kelana in Kelana Jaya, (comprising an office tower, retail lots and shop offices), tenants often list integrated security system, sufficient parking lots, accessibility to major highways and public transport, supporting amenities in close proximity (post offices, banks, eateries) and proper infrastructure as the most desired criteria for offices.

Tan Lee Koon, Managing Director of GuocoLand (Malaysia) Bhd

A possible overhang in the office market has been a topical subject in recent years and often discussed each time a new mega project is announced. Malaysia has been fortunate enough to enjoy sustainable economic growth of over 5 per cent per annum in recent years despite uncertainties in the global economy. This has prompted many new developments in the Klang Valley, including the government's mega projects like the TRX (Tun Razak Exchange) and KL Metropolis.

An influx of new office buildings due for completion later this year and 2014 will be sufficient to raise some alarm bells on the possible consolidation of rental rates and putting more pressure on older office building owners. Tenants will be spoilt for choice and owners may have to offer incentives like rent-free periods to remain competitive.

Views are divided on the office market scene and it really depends on who you talk to. Generally, the current market is stable and has remained resilient, both in terms of rental and occupancy rates. Average occupancy rate across all sub-markets remained stable – close to 80 per cent. The same goes with the rental rates – about RM6.50 psf monthly for Grade A office space in central KL.

However, there is a general consensus about possible market slowdown due to the rising supply of new office space. Office rentals are expected to come under pressure due to the incoming supply and expected limited demand growth. Newer buildings with better specifications and security, and green building features will continue to exert pressure on existing and older buildings.

In recent years, we have also seen the growing appeal of mixed development projects, such as our own Damansara City, the single largest and freehold integrated development in Damansara Heights, including two LEED (Leadership in Energy and Environmental Design) and GBI (Green Building Index) certified Grade A office towers, a lifestyle mall and a five-star hotel, and well served by two MRT stations. There is a growing trend of companies moving into office spaces in integrated developments that come with retail outlets and hotels apart from serviced apartments.

Preference of office locations depends on the nature of the business and other considerations such as branding, talent retention and of course budget. Banks, insurance companies, oil and gas companies, among others, will continue to have a preference for CBD locations. Today, more and more consultancies and professional services companies such as advertising, accounting, architectural and real estate have a preference for city fringe or suburban locations to take advantage of lower rents and better transportation links.

Excellent location and telecommunication connectivity aside, savvy office tenants today are now looking at other must-have essentials to enhance staff's welfare and attract new talents. Adequate parking space and excellent public transportation in addition to access to affordable food and variety, and after-work recreation facilities will rank highly today. It is not uncommon for job seekers requesting information about food and availability of parking before signing the dotted lines. This explains why many companies, large and medium-sized, have a preference for the one-stop convenience offered by newly developed integrated projects.

See Kok Loong, Director of Metro Homes Sdn Bhd

My view is that the current office market is undervalued in terms of rental per month, in relation to countries like Hong Kong and Singapore as we have not been able to draw in regional offices of MNCs (Multinational Corporations) into Malaysia in a big way, except for oil and gas companies.

An overhang or oversupply could definitely happen and the only solution would be for the government to draw up policies that are friendly and attractive enough to attract major international companies to choose Klang Valley as their regional office or hub, e.g. in finance, trading, IT, etc.

The main issue faced by the office market is that our yields are too low compared to capital value, dragging it down. For example, if our average rent is only RM5 psf, the annual rent would be RM60 psf. With a yield of 5 per cent, the capital value is only RM1,200 psf.

Some residential units in the city are selling for more than RM 1,200 psf. Therefore, many developers would rather develop and sell SOHO (Small Office/Home Office) or service apartments to unlock value instead of constructing an en bloc office tower.

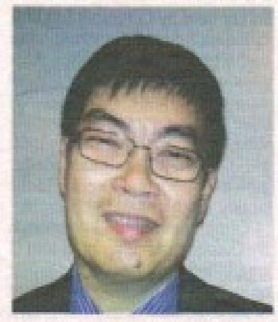
Table 1

Note: 1Q13 – based on restructured sample buildings and gross asking rents

Source: YYPS Research

*Sim... "**Improved transparency and corporate governance** vital in making Malaysia an attractive regional hub."*

*See... "**Yields in the office market are too low** compared to capital value."*



*James Tan... "Expect a **glut in the office market for the next decade.**"*

Table 2

Greater KL Market Statistics

Submarket	Inventory	Overall Vacancy Rate	Under Construction	YTD Construction Completions	Overall Direct Net Absorption	Grade A Average (RM/SQFT/MTH)	
						**4Q12	***1Q13
KL CBD	36,910,027	19.1%	2,978,242	688,997	198,282	7.56	8.46
KL FRINGE	35,373,964	26.4%	7,955,545	514,859	199,692	6.09	6.50
SUBTOTAL - KL	**72,283,991**	**22.7%**	**10,933,787**	**1,203,856**	**397,974**	**6.91**	**7.51**
**SELANGOR	23,199,369	21.6%	5,414,263	0	95,745	4.58	4.94
CYBERJAYA & PUTRAJAYA	4,150,452	56.9%	503,416	993,518	-3,748	4.60	4.93
TOTAL	**99,633,812**	**23.8%**	**16,851,466**	**2,197,374**	**489,971**	**RM6.20**	**RM6.87**

** Rental rates reflect net effective rate MYR psf/year; ** Inventory of Selangor excludes Cyberjaya*
*** Grade A Average Rent: Net Effective Rent reported for 4Q12 and*
**** Grade A Average Rent: Gross Asking Rent reported for 1Q13*
Source: YYPS Research, Napic report (third quarter 2012)