30 June 2008: Special Focus: What's in store for office space?

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The recent major hike in petrol and building material prices, as well as changes in the political landscape, have inevitably caused some apprehension among investors. Has this affected the office space market? Experts generally believe that the Klang Valley office space market will continue to see positive growth although some feel growth may slow down considering the uncertainties. Prices and rents of offices on the fringes of the city centre, such as Damansara Heights and KL Sentral, however, will continue to experience a rapid increase as they play catch up with the values in the city centre.

Christopher Boyd, executive chairman of Regroup Associates Sdn Bhd, expects the Klang Valley office market to remain strong as there is still a general lack of supply of office space. As a result of limited supply of quality office space, rent rates have risen significantly over the last 12 to 24 months. An indication of robust demand is also the pre-letting of office buildings that have not been completed, which Boyd describes as a first in Malaysia. Coupled with this, is the strong demand for bigger office space, and acquisitions by local and foreign financial institutions, including real estate investment trusts (REITs).

"This year, you will see the completion of 10 office buildings in Kuala Lumpur with a total net lettable area of 3.34 million sq ft, of which 2.48 million sq ft have been pre-let," says Boyd.

Next year, nine buildings, comprising 2.92 million sq ft, will be completed, of which 909,000 sq ft have been pre-let. One of them is the GTower at Jalan Tun Razak, which Boyd believes is coming into the market at the right time. It offers 32,000 sq ft per floor to meet pressing demand for big office space, says Colin Ng, head of corporate investments at Goldis Bhd, developer of GTower.

"Over 2 million sq ft of free float is really not a big number because in a good year, the market can absorb 3 million sq ft," says Boyd. Hence, by his assessment, the market is expected to remain strong. In 2010, three buildings are scheduled to be completed (1.2 million sq ft have been pre-let).

"We are in uncharted territory now in terms of office space. Rents are higher than ever before. Tenants have to get their head around a whole new price regime. "The current average rent and price of Kuala Lumpur prime office space could rise between 10% and 20% the next 12 months," says Boyd.

The situation, however, has not always been like this. There had been little growth in rent since 1998 until about nine months ago. In 1998, during the Asian financial crisis, when the Klang Valley experienced an oversupply of office space, occupancy was down to 70% and there was some 14 million sq ft of vacant space. From 2001 to 2006, there was little new supply — a reaction to the soft market. Moreover, there was a freeze by the Kuala Lumpur City Hall on the construction of office buildings of more than 20 storeys.

"It has taken eight to nine years for the oversupply to clear. Today, occupancy has risen to 85% in the Klang Valley," he says.

"We've already seen a substantial increase in values in the last 18 months from RM550 psf to more than RM1,200 psf in the Golden Triangle area. That has been the result of increasing rent appreciation plus a lower acceptable yield," says Boyd. "Up until late 2006, most investors, who were on the lookout to buy office buildings, tried to buy buildings that gave yields of 7%. Now with increasing competition from overseas funds, yields are down to 6%."

However, Zerin Properties head of investment Francis Quah is less sanguine and believes that in the next 12 months, prices of Grade A buildings in the city centre may consolidate, where we might see prices increase by about 5% to 10%.

"This is due to people taking a "wait-and-see" approach compared with six months ago

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when people were more gung-ho. On the other hand, foreign investor funds talk to us every week and they see Malaysia as an attractive pick," he says.

Brian Koh, DTZ Nawawi Tie Leung Sdn Bhd's executive director of investments, says growth in the service sector has been very strong over the last two years, providing support to the commercial market. "Current uncertainties will certainly affect some of the proposed expansion, or upgrading plans but we are still optimistic that the office market has some momentum, at least for the next 18 months, until more new supplies are completed in late 2009/2010," he says. In most markets, unlike Malaysia, residential property prices are higher than commercial property. But Mervin Chow, an analyst at OSK Research, says it's hard to envisage prime office space being priced on a par with high-end condos (RM1,600 to RM1,800 psf) in this current supply cycle (2008 to 2009) due to emerging competition from decentralised office areas, a more moderate economic outlook and that most multinational companies will likely put on hold their business expansion plans pending a clearer picture on the political and economic fronts.

This is the fundamental argument for both rent growth rates and capital values to potentially reach its peak in 9 to 12 months' time, says Chow. Furthermore, if Bank Negara raises interest rates amid the current high domestic inflation, it may put additional downward pressure on property prices, he adds.

Decentralisation

The experts agree that prices outside the city centre are rising quickly to match what is offered in the city centre. Regroup's Boyd says, "At KL Sentral, we are already seeing lettings at RM8 psf, partly due to the MSC status and transport access. I am not surprised if rents will hit RM10 in the near future."

According to Abraham Philip Jacob, head of business space at Zerin Properties, the average rent in Damansara Heights is now between RM4 and RM4.50 psf compared to 1½ to 2 years ago, when it was between RM3 and RM3.50 psf. In three years to come, we could be looking at a 15 to 20% increase in this area.

"Menara Milenium, which is considered the benchmark in Damansara Heights, is already doing about RM5.50 to RM5.80. The Gardens Office is asking for RM6. And there is talk that BSC Office Suites, to be completed next year, will be setting a new benchmark in the area," Quah adds.

The BSC Office Suites is a project being developed by Bandar Raya Developments Bhd (BRDB). Its CEO, Datuk Jagan Sabapathy has this to say to investors.

"I am cautiously optimistic; provided that you are looking at properties in the right location — the city (From Cap Square to KLCC), Damansara Heights, Bangsar and Mont'Kiara. These locations have location advantage.

"If you look at the history of increases in energy prices, a period of adjustment follows, people will reset their prices. Whilst Malaysian asset prices go up, outlook will remain good, and it will settle at one point. So, you have a window to invest in Malaysian properties that give good yields."

Petaling Jaya commercial space rents, in areas like Damansara Perdana, have some upside potential as well, says Regroup's Boyd. "This year, we are going to see six buildings completed in suburban Klang Valley — two million sq ft in the market. Next year, about 1.42 million sq ft will be completed, with 50% already pre-let," he says.

On Petaling Jaya, DTZ's Koh says, "There is a strong middle-class catchment area here. We have seen Jaya 33 in Section 14 successfully leased, and a strong pre-commitment at Surian Tower in Mutiara Damansara. We have also noted that the Internal Revenue Board as well as a public-listed company have taken up 200,000 sq ft each at the underconstruction PJ Trade Centre in Damansara Perdana. In short, we have seen a strong recovery in the Petaling Jaya commercial market for the last three years, and there aren't too many Grade A offices here yet."

Malaysian properties are the cheapest in the region — is this a good enough reason to invest?

"Pricing real estate can be rather complex. It has to do with economic activity and historical trends. I believe it's cheap in Kuala Lumpur because the market has always been relatively well-balanced with no extreme shortage of supply," says Boyd. "I would say yes, 'cheapest in the region' is a valid reason to invest if you are willing to take a view of 5 to 10 years."

But Koh says, "Real estate markets are very much affected by local economic conditions, so straight regional comparisons are not realistic. However, by opening up the market to international players, a more "efficient market" has been created, which leads to better pricing for property owners. I would say the Malaysian market is priced realistically. The reason for this is there are no dominant property players, unlike in emerging markets, like Vietnam, where land ownership is tightly controlled by the state."

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Zerin's Quah thinks the hidden gems are in Kuala Lumpur's Jalan Sungai Besi, Jalan Loke Yew, Jalan Imbi, Pudu, and Titiwangsa because it's only natural for the city centre to "expand".

"If UDA (Urban Development Authority) announces they want to sell the Pudu Jail land, I am sure there will be a lot of people queuing to buy. If that starts developing, it would start an impetus to develop that area," says Quah.

"Heritage Row (Jalan Doraisamy) is an example where redevelopment has added value. Right now, land use in Pudu, Titiwangsa and Imbi is not optimal." says Jacob.

Quah also cites examples of projects which seem to be doing well in such areas.

"Units at Fraser Park, off Jalan Loke Yew, for example, were fully sold. I think Mah Sing's Southgate at Jalan Sungai Besi is a natural extension of Fraser Park's concept. Southgate has done well in terms of sales, and also D7 in Sentul by YTL, which were snapped up within two hours," says Quah. "There are not many office suites that are sold on a strata basis to individual investors."

When asked about Southgate, Andy Chua, deputy chief operating officer of Mah Sing Properties Sdn Bhd, says freehold commercial properties like Southgate would expect good capital appreciation, with expected rent yield of more than 8%.

"There is definitely going to be a slowdown. But an astute buyer will recognise a good buy irrespective of market sentiments," he says.

Boyd says the newly-proposed LRT stations will give insight to where growth areas will be for commercial development. The new LRT lines will benefit areas along Jalan Damansara, Bandar Utama, Mutiara Damansara, Kota Damansara and also Subang.

"There has never been much supply in Bangsar, and Damansara Heights is 'full house'… so these suburbs make great office locations in my opinion," he adds.

Outlook in Johor Baru

Johor Baru's office market has shown gradual improvement in occupancy rate over the last few years because new supply has been limited, observes Boyd. It's a small market with 500,000 sq ft supply. Current average occupancy is 65%. Rent for good buildings is RM2 to RM2.50 psf. Rents won't move up a lot until occupancy rises to 85%, he says .

Despite the enormous disparity in rent rates between Johor and Singapore, it remains a challenge to attract people from across the border due to perceived security, availability of skilled labour and immigration crossing problems, says DTZ's Koh. Johor Baru office space rent is RM2.50 psf, compared with Singapore's S$23 psf.

Things are looking up, however, as Zerin's Quah says, "There are Middle Eastern investors and local developers looking into Johor. The plus point is that infrastructure, like roads, is there; so, if it's not a greenfield, I expect Iskandar Malaysia to 'fall into place' in about 5 to 10 years."

"S P Setia, for example, went there in the 1990s and are committed to Johor Baru. My impression when I visited Setia Tropika was that I thought the place is very well-designed, and there are security features," says Jacob. S P Setia is one of the top developers in Malaysia — it shows their level of confidence in Johor Baru's prospects, Quah adds.

Phan Yan Chan, general manager of Setia Tropika Sdn Bhd, feels that despite the current cautious market, there are opportunities to invest.

"Given the recent petrol price hikes and economic uncertainties, there will surely be some effect from buyers tightening their belts. However, many buyers will see this as an opportunity and the right time to invest," he says.