Initial design of Alibaba's hub. Photo courtesy: Alibaba

# E-commerce boom fuels warehouse wars

Logistics players are aggressively snapping up space, which may force other tenants to relocate to the Mainland as costs rise and leasing opportunities vanish.

When Alibaba's logistics affiliate snapped up a massive industrial site in Kwo Lo Wan in June, it proved that e-commerce players are the new kings of Hong Kong's industrial property scene. The site boasts 4 million sqft of strategic logistics space, and a consortium led by Alibaba's Cainiao Network will splurge $12b to turn it into a state-of-the-art logistics centre.

"E-commerce and data centres have been the two hottest topics in the industrial and warehouse market recently," says **Simon Smith,** head of research and consultancy at Savills Hong Kong. "The increasing demand for faster shipment of larger volumes of internet-related trade means newer and larger logistics centres with more automation and robotics are in high demand."

**Leasing momentum will continue to be boosted by stronger tech-related demand.**

"This year the industrial sector is characterised by three factors – lack of new supply, tech-driven logistics, and flight-to-quality relocations as a result of building conversion or redevelopment," says **Samuel Lai**, senior director for advisory & transaction services - industrial and logistics at CBRE Hong Kong.

The industrial property sector will also be heavily influenced by the completion of new infrastructure projects. The Guangzhou-Shenzhen-Hong Kong Express Rail Link is set to open in September, shortening the travel distance amongst these three major cities in the Greater Bay Area. The Hong Kong-Zhuhai-Macao Bridge and the Liantang/Heung Yuen Wai Boundary Control Point, both of which will be up and running by end this year, will create further demand for logistics facilities in Hong Kong, Lai notes.

**Selected leasing transactions in Q2 2018**

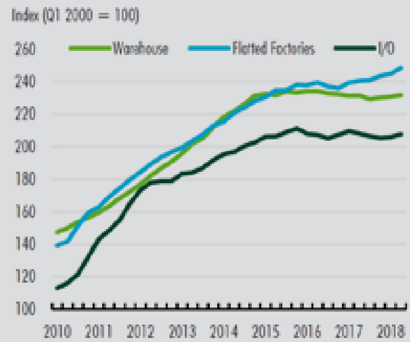
| Property | Location | Type | Size (GFA sq. ft.) | Indicative Rental (HK$/sq. ft./mth) | User |
|---|---|---|---|---|---|
| Multiple floors, Tsuen Wan Industrial Centre | Tsuen Wan | Warehouse | 136,000 | $12 | Manufacturing |
| En-bloc, Sam Wah Cold Storage | Tuen Mun | Warehouse | 100,000 | $10 | E-commerce |
| Unit A-B, 6/F & Unit A, 9/F, Dynamic Cargo Centre | Tsuen Wan | Warehouse | 49,659 | $10 | Logistics |
| LG/F, Wah Shun Industrial Building | Kwun Tong | Factory | 34,100 | $7 | Automotive |
| 5/F, Safety Godown | Kwai Chung | Warehouse | 32,765 | $11 | Food & Beverage |

*Source: CBRE Research, Q2 2018*

## Tech-driven demand

Leasing momentum will continue to be boosted by stronger tech-related demand. In the second quarter alone, an electronic goods e-marketplace leased 100,000 sq. ft. in Tuen Mun to support business growth. In Shatin, meanwhile, two data centre operators committed to a atotal of 344,000sqft. of space in two industrial buildings, which they plan to convert into data centres for expansion.

**Rental index**




*Source: CBRE Research, Q2 2018*

"The increasing popularity of internet shopping, cloud services and blockchain technology all translate into high demand for cyber-storage space, and thus higher demand for high-tier, well managed data centres," says Smith.

CBRE's Lai adds that multi-national, mainland Chinese and local companies running businesses related to technology and innovation, e-commerce as well as smart solutions are active in expanding and settling in Hong Kong. "The upside is that technology is rising as a demand driver. They fuel the market and energize the sector," he shares.

However, the rising demand from tech players will only exacerbate Hong Kong's already dire industrial space shortage. "New transport infrastructure, along with the growing demand arising from e-commerce and from non-traditional industrial users such as mini-storage and data centre operators will likely underline demand for warehouses in Hong Kong over the medium-to-longer term," says **Dennis Ma,** head of research at JLL Hong Kong. "Supply, on the other hand, remains constrained with almost all new prime warehouses built over the past 10 years arising from Government land sales. Moreover, industrial stock in general, continues to be shrinking as more industrial areas are rezoned for non-industrial use," he warns.

"Rising demand from tech firms makes the supply issue even more eminent and prominent. To support the market growth, adding more industrial supply should be the top priority for policy stakeholders," Lai adds.


Simon Smith


Samuel Lai


Denis Ma

**Will supply woes kill Hong Kong's data centre dreams?**

A stable and pro-business environment bodes well for Hong Kong's ambitions of being a consolidation point for data centres in North Asia as cloud providers and Chinese powerhouses continue to set up shop in the SAR with AWS, Microsoft and Mainland-based BAT amongst the big-ticket names in the scene.

Global Switch earlier opened the first phase of its Tseung Kwan O facility by end-2017 as it aims to build up a total capacity of circa 60 MW whilst Mega Plus boasts of a 24 MW build, data from real estate consultant JLL show.To capture the opportunity from the region's growing data connectivity, a 2.74 hectare-site was recently released by the government in Tseung Kwan O with bids due by the end of 2018. The site could yield in excess of 1m sqft and a potential capacity of up to 200 MW, lending support to Hong Kong's data center dreams.

"The primary markets of Singapore, Hong Kong, Sydney and Tokyo have been the preferred locations for data centre investments. These cities' robust infrastructure, connectivity and relative ease of doing business will see them remaining as operator and investor favorites for the foreseeable future," the report's authors said.

Hong Kong's estimated capacity ranks third in the so-called Big 4 data center markets at 285 MW which trails behind Singapore at 330 MW and Tokyo at 315 MW. Sydney is also making its mark with an estimated capacity of 197 MW. However, the city's severe land shortage could hit these ambitions which could push costs up until new sites could be unlocked. Additionally, the site at Tseung Kwan O may not necessarily cool demand as core and shell could be phased over 7 years and delivery of actual facility could be phased over a longer period.

As such, parties have been doubling down to unlock more land options where it competes with housing in land requirements."In the meantime, pursuit of brownfield options seem to be the preferred strategy for several operators. They provide an alternative choice in terms of location to TKO," it added.

If relevant parties do not get their act together soon, Hong Kong may run the risk of falling out of the Big 4. "China may become an alternative in future," the report's authors noted.

**Too many tenants, too little space**

If Hong Kong fails to address the lack of industrial space, some companies may soon opt to transfer to cheaper cities in the Mainland to cut costs, particularly on back of improved transport connectivity with Hong Kong. "Today, Hong Kong is one of the most expensive warehouse markets in the region," notes Ma. "The shortage of industrial stock has also been cited by industry participants as a key factor behind why the city's has fallen behind in the development of its technology sector when compared against its peers."

The industrial space dearth is also the reason why some manufacturers have been unable to relocate their assembly lines back to Hong Kong from mainland China under the territory's re-industrialisation initiative. "The lack of affordable warehousing options has seen a lot of occupiers move into 'tin-sheds' in the New Territories, which are largely situated on brownfield sites and areas that the Government is exploring to redevelop as part of its broader solution to the city's housing supply issues," Ma notes.

CBRE's Lai highlights that whilst almost 1.1 million sqft of new industrial land has been released this year, most of the new supply is in new buildings that are divided into small units which makes them unsuitable for the needs of large industrialists. "The key challenge remains the shortage of supply. The two logistics sites sold by the government this year will not be completed any time soon and there is no new supply scheduled for 2019 and 2020," Lai says. "Hong Kong has been constantly short in industrial land supply and corporations in need of large floor plates struggle to find available sites.

As improved infrastructure enables better connectivity, Lai warns that some companies will find alternatives in nearby cities such as Zhuhai, Dongguan, Zhongshan and even Huizhou to save land costs. CBRE Research data shows that among the Greater Bay Area, Guangzhou, Shenzhen and Hong Kong already handle the largest flow of goods in the region. However, running logistics centres in these eastern cities is costly, with monthly rents averaging RMB40 per sqm and rents in Hong Kong reaching around RMB117 per sqm The monthly rents of logistics centres in western cities average RMB30 per sqm.

"With several major railways and roads launching to connect the eastern and western cities, some logistics operators have moved their delivery hubs out west. We have seen some businesses that are involved in making furniture or luxury items, of which instant delivery is not required, relocating to other Guangdong cities," Lai says.

**Redevelopment and relocation**

Another major trend shaking up the industrial property sector is the ongoing redevelopment of former industrial redevelopment of former industrial sites into residential properties, which will only heighten the lack of supply. For instance, two old warehouses, Yuen Fat Wharf & Godown and Kerry Hung Kai Godown in Cheung Sha Wan, with 1.5 million sq. ft. GFA, will likely be redeveloped into 3,140 housing units.

**Selected sales transaction in Q2 2018**

| Property | Location | Type | Floor | Size (GFA sq. ft.) | Price (HK$ mil) | Price (per sq. ft.) |
|---|---|---|---|---|---|---|
| En-bloc, Cargo Consolidation Complex | Kwai Chung | Warehouse | En-bloc | 266,200 | 2,000 | 7,513 |
| En-bloc, Brilliant Cold Storage (Warehouse 2) | Kwai Chung | Warehouse | En-bloc | 293,850 | 1,600 | 5,445 |
| Mee Wah Factory Building | San Po Kong | Factory | En-bloc | 99,991 | 850 | 8,501 |
| 70% stake, Success Centre | Kwai Chung | Factory | Partial Ownership | 165,580 | 596 | 3,535 |
| 90% stake, Wing Hing Lee Industrial Building | Kwun Tong | Factory | Multiple floors | 97,200 | 573 | 5,890 |

Source: CBRE Research, Q2 2018

**Two old warehouses, Yuen Fat Wharf & Godown and Kerry Hung Kai Godown in Cheung Sha Wan, with 1.5 million sq. ft. GFA, will likely be redeveloped into 3,140 housing units.**

"The redevelopment trend continues to heat up in Hong Kong. We have seen 11 properties totaling H$5.3b change hands with the purpose of redevelopment this year. Many investors are eyeing the redevelopment potential of industrial buildings and plan to convert the higher quality warehouses into data centers or technology-related space. This trend also triggers relocation needs, which boost leasing activities," Lai says.

Savills' Smith adds that leasing activity in the traditional warehouse segment remained firm, partly because of displacement demand from older warehouses being redeveloped by new owners. "Another notable trend was the relocation of some electronics manufacturers to traditional warehouses, some looking for higher specifications whilst others were looking for expansion space. Meanwhile, the modern warehouse leasing market has remained active as many high-end, fast-moving logistics operators have successfully emerged from last

ON THE MOVE

## Here are the biggest movers and shakers in Hong Kong's industrial property scene

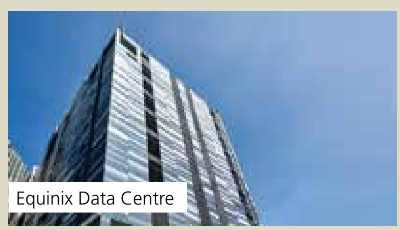
Amongst the largest industrial real estate deals this year is the sale of Cargo Consolidation Complex. The property, which has already been converted into a data centre and where average rents are expected to rise from $22 per sqft currently to $28 per sqft over the next six years, was sold to a local investor for $2b ($7,513 per sqft), with a buy-in cap rate of 3.5% eventually rising to 4.4%.

Meanwhile, Brilliant Cold Storage II was sold to investor Tang Shing Bor for $1.55b ($5,275 per sqft). Experts expect that with the current lease due to expire next year the new owner could opt to convert the premises to a higher-yielding use, possibly a data centre. Based on the GFA of 293,850 sqft (27,300 sqm), the average price was $5,517 (USD707) per sqft. The value of the property had increased more than three times in nine years, as the previous owner bought it for $390m (USD50m). Further, the Mee Wah Factory Building was sold for $1.25b to investment firm PAG.

Elsewhere, companies that are engaged in businesses related to technology, e-commerce and high value logistics have entered the scene this year. Equinix, the world's largest IBX data center & colocation provider, expanded their footprint in Hong Kong by leasing a space of nearly 400,000 sqft in Shatin. GDS, a leading Chinese data center operator, expanded their footprint in Hong Kong by closing an en-bloc industrial building transaction.

Possehl Electronics signed a lease for a 136,000 sqft unit in Tsuen Wan Industrial Centre ahead of the redevelopment of its current space. Elsewhere, Tsit Wing Coffee and Dongnam Logistics, both of which are tenants in the Winner Godown redevelopment, relocated to a 33,000 sqft space in Safety Godown and a 32,000 sqft space unit in Hutchison Logistics Centre. The logistics sites on Siu Leng Shui Road in Tuen Mun and at Hong Kong International Airport were awarded in H1 for building smart logistics solutions and e-commerce operations.


Brilliant cold storage


Equinix Data Centre


Dyson's new R&D centre


Hutchison Logistics Centre

year's market downturn unscathed, and are now again in expansion mode, thanks to growing air and sea freight volumes," he notes.

Ma highlights that the gentrification of older industrial areas is also drawing a lot of investors towards industrial properties as a more affordable option for offices. These spaces are particularly popular with owner-occupiers who are looking at long-term investments. "Buildings approved for wholesale conversion can effectively be used for non-industrial uses for the lifetime of the building. Areas such as Kwun Tong and Kowloon Bay, which form part of Kowloon East—the city's 2nd CBD—and emerging office clusters in Cheung Sha Wan and Kwai Chung in Kowloon as well as Wong Chuk Hang on the south side of Hong Kong Island, have seen significant investment activity," he says.

**Looking ahead**

In spite of rising uncertainty and heightened volatility, experts are confident that Hong Kong's industrial property sector is well-positioned to weather the storm. "The industrial and logistics market is resilient. Despite all the volatility in other property subsectors, the industrial market is stable, underpinned by sustainable demand. Hong Kong is famous for having the priciest commercial and residential properties in the world but industrial market is getting more attention due its relatively lower price tag and the growing yield," says Lai.

As an illustration, Lai notes that the land value of a Kwai Chung industrial land lot is $4,000 per sqft and for a brand new industrial building there, the property value is around HK$9,000 per sq. ft. But an office building in the same district could cost up to $10,000 - $12,000 per sqft and the price can get to over $40,000 per sqft for offices in Central. "For the yield, the industrial sector is around 3-4% whilst office is below 2.5%. That explains why this sector has gained pace in recent years and will continue to strengthen in the years to come," he says.

"With global trade weakening, warehousing demand is expected to ease. Yet, based on deals in progress, vacancy is expected to tighten after rising through the first half of 2018 and coupled with the absence of new supply, we expect warehouse rents to remain broadly stable over the coming 12-months though and risks to our forecast will be on the downside owing to the potential escalation of the US-China trade war," Ma notes.

**The land value of a Kwai Chung industrial land lot is $4,000 per sqft and for a brand new industrial building there, the property value is around HK$9,000 per sq. ft.**

**Map of major Hong Kong industrial areas**

*Source: CBRE Research*

THE VIEW

## Will the number of industrial property transactions in Hong Kong drop amidst the brewing trade war?

**Denis Ma, Head of Research at JLL in Hong Kong.**

"For the warehouse sector, yes, but the severity and extent remains unclear at this stage. We think that leasingdemand will ease but not necessarily to the extent where occupiers start downsizing, unless the trade-war escalates significantly. The impact of the trade war on the broader industrial market will depend on whether it's the broader economy beyond just the external trading sector.

The prime warehouse market continued to be hold up reasonably well through the first half of 2018 though concerns of a growing trade war between the US and China, the city's two largest trading partners, saw the vacancy rate rise to a near 10-year high and rents retreating by 0.3% q-o-q in the second quarter.

Overall, rents are still up 0.1% for the first half of the year. Still there are bright spots in the market, air-freight cargo volumes at Hong Kong International Airport (HKIA), the world's busiest air cargo airport in 2017, continued to record solid growth through the first half (up 4.4.% y-o-y) offsetting a 3.9% y-o-y drop in container throughput at the city's major ports.

In the broader industrial property market, where properties are largely used as ancillary offices and light industrialactivities, market performance more closely follows the trends of decentralised office markets. As a result, flatted factories rents been able to nudge higher, up 2.8% through the first half of the year.

The strong demand for industrial property from owner-occupiers has led to most new buildings completed in recent years being sold on the sales market and having little impact on the rental market."

**Samuel Lai Senior Director, Advisory & Transaction Services Industrial & Logistics, CBRE Hong Kong**

"The impact of the trade war to industrial property transactions is minimal thus far. The reason for the resilience is that the local industrial market mainly provides goods to local and mainland Chinese markets.

The logistics sector is indeed the most exposed due to the fact that China and U.S. are Hong Kong's largest trading partners. Uncertainty reigns but the demand appears to be undented as evidenced by a number of large deals in the market this year.

But investors should watch closely how the trade conflicts evolve and also how the interest rates hikes may impact the investment environment."

**Simon Smith, head of research and consultancy at Savills Hong Kong**

"The logistics/trading related leasing transactions may drop in the short term, but not sales volumes as investors are still keen on industrial premises. Leading logistics operators have shown their confidence in the long-term prospects of the local logistics sector by committing substantial capital to two logistics sites sold in the second quarter of the year."