Special Edition

COVID-19 & The Klang Valley Office Market

Thoughts and Perspectives

The Klang Valley office market has been under pressure for the last few years with the continuing mismatch between supply and demand. Landlords have had to adopt aggressive leasing strategies to attract new Tenants and retain their current Tenants. Prior to the onset of the COVID-19 pandemic, the strong expansion in the co-working, technology and shared services sectors coupled with active migration from older office stock to newer buildings indicated that there would be improvements to the corporate office market in 2020.

However, the widespread transmission of the novel coronavirus worldwide has led many countries to impose lockdowns and travel bans to contain the outbreak resulting in severe disruptions to lives, economies and societies.

In an attempt to flatten the infection curve, the Malaysian Government implemented a Movement Control Order (MCO), which has been on-going since 18th March 2020.

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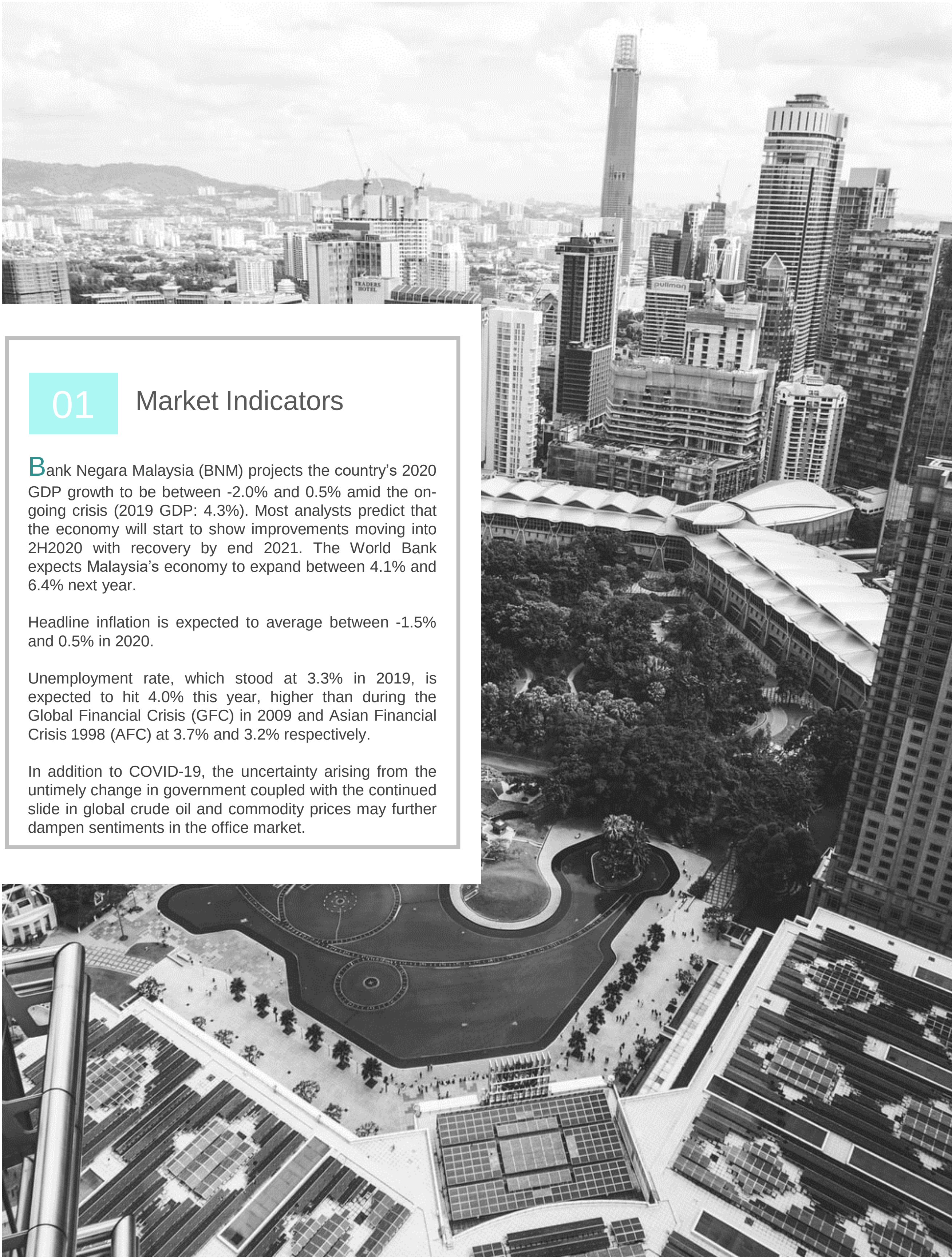


01 Market Indicators

Bank Negara Malaysia (BNM) projects the country's 2020 GDP growth to be between -2.0% and 0.5% amid the on-going crisis (2019 GDP: 4.3%). Most analysts predict that the economy will start to show improvements moving into 2H2020 with recovery by end 2021. The World Bank expects Malaysia's economy to expand between 4.1% and 6.4% next year.

Headline inflation is expected to average between -1.5% and 0.5% in 2020.

Unemployment rate, which stood at 3.3% in 2019, is expected to hit 4.0% this year, higher than during the Global Financial Crisis (GFC) in 2009 and Asian Financial Crisis 1998 (AFC) at 3.7% and 3.2% respectively.

In addition to COVID-19, the uncertainty arising from the untimely change in government coupled with the continued slide in global crude oil and commodity prices may further dampen sentiments in the office market.

02 Government Initiatives

Prior to the MCO period, the previous Government had announced a RM20 billion economic stimulus package to cushion the impact of COVID-19. Subsequently, the current Government launched two additional stimulus packages, worth a combined RM240 billion, to provide relief for individuals and businesses. The latest package, PRIHATIN Plus, was particularly directed towards the Small Medium Enterprises (SMEs), which as stated by Department of Statistics Malaysia (DoSM), employ circa 70% of the country's workforce. Along with wage subsidies and access to low interest loans, the Government is also offering tax deductions to private Landlords who provide rental assistance to their SME Tenants in the hope they be encouraged to lend their support.

PRIHATIN Package for Small Medium Enterprises (SMEs)

Announced on 6th April 2020

Rental Waiver / Discount from GLC Landlord
for the months of April to June 2020.

Rental Waiver / Discount and Tax Deduction for Private Landlord
who provide rental reduction or waiver which is equivalent to the amount of rental reduction for the months of April until June 2020. Rental reduction is at least 30% of the original rental rate for that particular period.

Wage Subsidy
ranging from RM600 to RM1,200 per month per employee (depending on company size) for staff earning RM4,000 and below per month for a period of 3 months from 1st April 2020.

RM3,000 Grant for Micro Businesses
under PRIHATIN Special Grant.

Zero Interest Rate
for micro credit schemes with BSN or TEKUN Nasional.

Levy for Foreign Workers
25% discount on foreign worker permits that expire on 1st April to 31st December 2020.

Auto Moratorium
for submission of statutory documents to SSM for 30 days from the last date of MCO.

For more information, please visit
PM's Speech: 6th April 2020
**The above is extracted from PM's speech and subject to being gazetted*

03 Office Market Outlook

It is too early to make concrete determinations on the full implications of COVID-19 on the Klang Valley real estate market, especially as recovery is highly dependent on how other countries fare in battling the pandemic. If the knock-on effects of the MCO and the pandemic is anywhere close to the Asian Financial Crisis (AFC) in 1997/8, historically, prime office rents in the Golden Triangle declined by about 15% post-AFC as tracked by the National Property Information Centre (NAPIC). The market did in time recover, although whether the current situation will mimic the earlier pattern remains to be seen. The oversupply of office space will also make recovery a long, drawn-out process.

The Immediate Challenge

Since the start of the MCO, leasing activity has slowed down immensely as real estate plans have either been delayed or cancelled altogether as businesses aim to control their cashflows and limit spending. Although the outbreak may be a short term challenge, the financial impact may prompt companies to consider downsizing, closing down branches or if available, exercising their contraction rights to reduce occupational costs. This could potentially lead to a dip in the overall occupancy, especially as companies look to avoid non-essential capital expenditure until the market recovers.

While larger enterprises are expected to have the strength to weather this storm, it is the smaller to medium enterprises that are likely struggle to meet their financial obligations. Companies may look to their Landlords for rent waivers or deferred payments. For companies which do not fall in the SME category, Landlords will not have any tax benefit for accepting such requests and hence, they could either face a reduction in their rental income for 2020 or risk losing Tenants to insolvency or cheaper real estate.

Subdued Demand and Further Pressure on Rental

The pandemic will hopefully be temporary, but the repercussions on the rental market will be felt long after it has been contained. Subdued demand for physical office space will likely further dampen the office market, which has already been struggling to keep up with the oversupply. Effective rental rates are expected to face intense downward pressure, especially as more space come into the market and organisations adopt a wait-and-see approach before embarking on any major decisions which require capital expenditure.

Not all industries are expected to contract, and some may grow in coming years. Businesses related to e-commerce, hygiene and healthcare, insurance, technology and business process outsourcing are performing well with increased demand and are adapting to the changing landscape.

Delays in Upcoming Supply

There is an estimated 4.23 million sq ft of office space scheduled to be completed by the end of 2020. However, delays in construction progress are expected with work slowing down / coming to a halt during the current MCO coupled with supply chain disruption. Although the Government has recently allowed certain construction activities to resume, the additional procedures which involve stricter social distancing and fewer onsite workers are likely to lengthen the development period.

These delays may cause a domino effect as Tenants who were scheduled to move into their new premises will have to negotiate to extend their current tenancies while owners who have taken financing will have their projections affected. The incoming supply coupled with the reduced demand will exert further pressure on rental rates as Landlords will likely have to offer greater incentives to lure Tenants. Notable buildings nearing completion are Affin Tower and the new HSBC HQ in Tun Razak Exchange, Menara TCM, TS Law Tower, Legasi Kampung Bharu, Permata Sapura and Menara Star 2.

Co-working

Co-working operators, behind some of the Klang Valley's largest space take-ups in recent years, are now facing a challenging period. Their overall occupancy may decline in the short term as SMEs, the traditional occupiers of co-working space, may struggle to overcome the economic downturn. With many members not paying fees during the MCO, co-working operators with limited financing and/or Landlords unwilling to provide rent waivers or deferments, will have to shut their doors or be acquired by opportunistic larger players. Access to working capital is going to make the difference between success and failure for many co-working operators. Eventually, co-working space should stabilize as small and large enterprises lean towards flexible leases and multi-location teams as part of their Business Continuity Plans (BCP).

04 Looking Beyond the MCO & COVID-19

The sudden outbreak has inadvertently caused organisations to re-evaluate not just *where* they work, but *how* they work. Prior to the MCO, companies were already implementing their BCPs or rapidly trying to develop them. As companies prepare to go back to work, the need to keep staff safe with social distancing measures (e.g. remote working from home, team rotations, or multiple locations), while trying to keep their businesses functioning will continue to be a challenge. The pandemic will eventually subside, but the repercussions on the rental market and occupier behaviour will likely be felt long after.

Flexibility and Agility

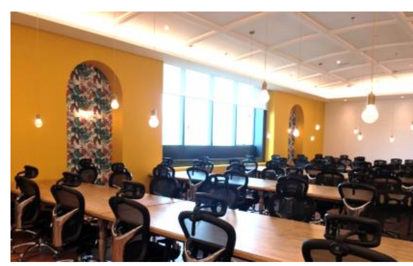
Organisations that need to expand or shift offices will likely opt for fitted space or flexible space to save CAPEX and mitigate risk amid this uncertain business environment. The ability to remain nimble and agile will be important for companies wanting to avoid getting locked into long leases. The Core and Flex model, where organisations have flexible work arrangements with employees to work remotely across multiple locations while maintaining their main offices, was already trending prior to COVID-19 and will become prevalent moving forward. The MCO has left many services and businesses with no other option than working from home although this arrangement does not work for everyone. Productivity can suffer due to distractions, unstable broadband connectivity, data breaches, breakdowns in communication, and more. However, operating from smaller offices in a flexible arrangement would allow employees to work closer to their homes and in conducive environment.

Digital Adoption

The MCO has accelerated the use of technology into everyday business. Video conferencing, cloud-based servers and other tools for communication and collaboration, have proven that organisation-level remote working is possible. For some industries that do not require a large physical presence, the move towards remote working as an additional perk to attract employees may prove to be a long-term benefit.

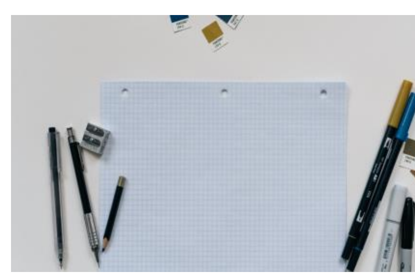
Space as a Service

Neither flexible space nor digital adoption spell the end of office space, but it does indicate the move towards efficiency and functionality. There is still a need to maintain an office for operations, sense of work-community, and for those who do not find remote working on a full-time basis productive. Organisations may move towards less space overall, but may now pay more attention to how work space can improve their businesses and retain talent.



Outsourcing

Organisations may also explore outsourcing certain functions to save overheads. With Shared Services Outsourcing (SSO) and Business Processing Outsourcing (BPO) operators offering stringent Service Level Agreements and Key Performance Indices along with flexible contract terms, organisations could look to them as a means to optimize their human resources, training and real estate costs.



Proactive Landlords

Landlords have always looked to competitive rental packages as a way to retain Tenants. However, beyond commercial terms, Landlords must now prioritize the health and safety of their end-users / Tenants. Corporate real estate planners will likely include analysis of a building's hygiene policies, ventilation and filtering systems, cleaning schedules, etc., when narrowing down potential offices.

In this capital-tight environment, occupiers will be looking for cost-saving opportunities. Matching such demand, Landlords should consider keeping fitted space from outgoing tenants, offering amortisation plans for fit-out costs, and shorter tenancy tenures.

It Will Pass and We Will Thrive.