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INDUSTRIAL 2.0: MORE THAN A FACE LIFT

ADDED VALUE JUSTIFYING INVESTMENT COST



Summary & Recommendations

Over 200 applications were submitted in the previous industrial revitalisation scheme between 2010 and 2016. More than half of all applications were approved by the government, representing 8.8% of total industrial stocks, and some have already been successfully converted to office, retail, hotel and data centre use.

In 2019, we expect the government will progressively implement a new revitalisation scheme which, among other things, should further relax permitted uses, include the conversion for transitional housing units, and widening the definition of *godown*.

According to the Lands Department, Kowloon East, including Kwun Tong, as well as Kowloon Bay and San Po Kong have the most industrial buildings with single ownership. San Po Kong should be the next popular spot for the revitalization scheme 2.0, and developers should consider this area as it has the highest number of single-owned industrial buildings 15-years old or older.

With CBD2 gradually taking shape, investors and developers should convert from industrial use into office and retail uses, so as to cater to the demand for relocation and high quality office space.

The revitalization plan for industrial buildings was first announced in Oct 2009 by the government, with the aim of providing more floor space for suitable uses in order to meet Hong Kong's changing social and economic needs, through conversion of industrial buildings into non-industrial uses, such as hotels and offices. The majority of industrial revitalisation applications during the previous scheme have been approved. The conversion for non-industrial use has driven a visible increase in rents and capital values with prices growing at a CAGR of 15.1% between Q2 2010 and Q4 2018.

In the 2018 Policy Address, the government reaffirmed a second version of the scheme with increasingly relaxed restrictions. For instance, the new scheme could allow any industrial buildings pursuing or having completed revitalisation to be converted into transitional housing for low-income families.

On 1 February 2019, the Development Bureau started allowing individual units of industrial buildings to follow five specific use types for an initial five-year period without any temporary waiver or fees. These include: art studios, office (audio-visual recording studio), office (design and media production), office (used by "specified creative industries"), and research, design and development centres. We expect that the rest of the revitalisation scheme will be launched progressively in 2019.

We also expect that Kowloon East, particular San Po Kong, will be the next popular spot for industrial revitalisation. With CBD2, Hong Kong's new second business hub after Central, gradually taking shape, the future completion of the Shatin to Central Link expansion of the MTR and an increasing population, demand for offices and retail malls should bring new opportunities for industrial building conversion in this area.



The former Cheung Kong Electronic Building in Kwun Tong, redeveloped under the previous revitalisation scheme into The Wave, consists of event space, co-working space, service offices, popup stores and F&B floors.

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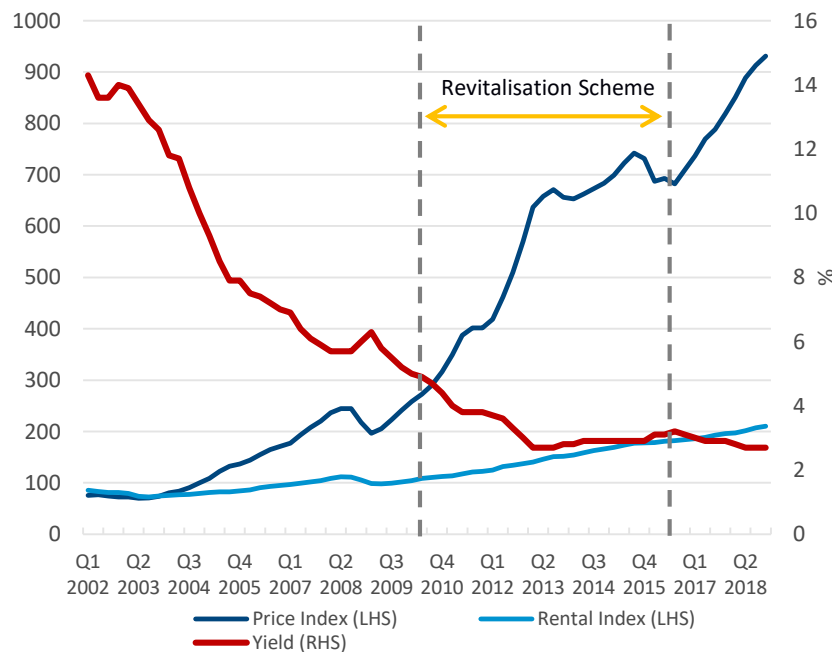
Recap of Scheme 1.0

RISING VALUES AND FALLING STOCK

The industrial leasing market remained strong during the past few years, due to increasing logistics demand driven by a strong economy and the growing e-commerce market, causing the vacancy rate at the end of 2018 to remain low at 5.7%. Investors and owners had taken advantage of the industrial revitalisation scheme by converting existing industrial buildings for non-industrial uses, such as offices, hotels and retail projects, to attain a higher value and investment yield.

According to the Rating and Valuation Department (RVD), the capital values of flatted factories increased by 151.8% between Q2 2010 and Q1 2016,

Flatted factories, price, rent and yield trends (1999=100)



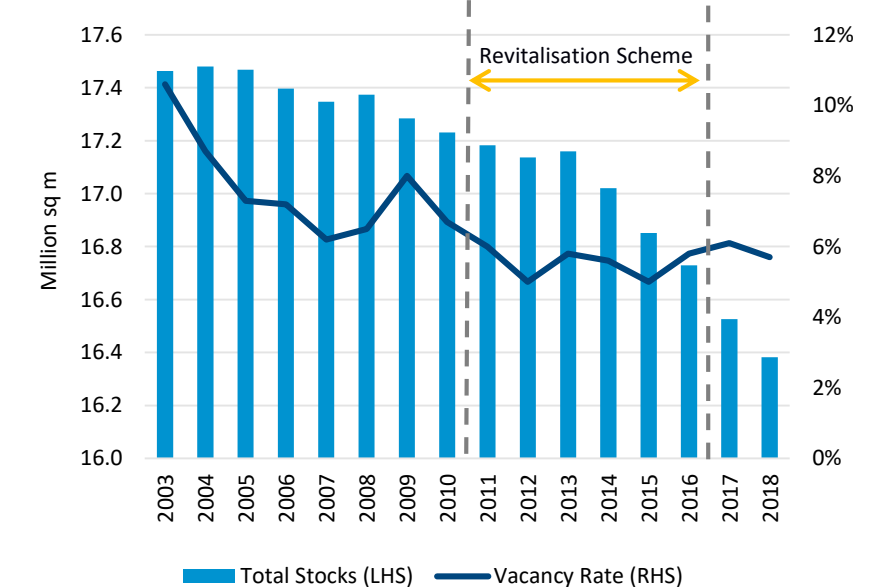
Source: Rating and Valuation Department, Colliers International

representing a CAGR of 17.7%. This was higher than the rental growth of 64.4% or a CAGR of 9.4%, despite industrial seeing the fastest growth of any property sectors in Hong Kong.

On the other hand, from 2010 to 2018, the total stock of industrial buildings decreased by 4.9% to 176.5 million sq feet (16.4 million sq meters), and the vacancy rates dropped from 6.7% to 5.7%. Bringing the total vacant space down by 18.2% to 10.1 million sq feet (937,900 sq meters).

Even after the first revitalisation scheme terminated, the capital values of industrial properties continued to be driven by the demand for redevelopment. Capital values increased by another 31.7% from Q1 2016 to Q4 2018, a CAGR of 9.6%.

Total stock and vacancy rate of flatted factories



Source: Rating and Valuation Department, Colliers International

During the first revitalisation scheme, flatted factories saw capital values increase by 152% between Q2 2010 and Q1 2016, representing a CAGR of 17.7%.

Rents also increased by 64%, with a CAGR of 9.4%.

Recap of Scheme 1.0

BRINGING A SECOND LIFE

With an increasing demand for non-industrial uses in Hong Kong, including office, hotel, retail, and data centres, the government introduced the industrial building revitalisation scheme in 2009, aiming to provide more floor space for suitable uses in order to meet Hong Kong's changing social and economical needs.

Starting from April 2010, the first revitalisation scheme was launched and applications began being accepted by the government. Industrial buildings at least 15 years old, along with other criteria, were eligible to apply for free waivers to change their use to office, retail, hotel or data centre use. Although the revitalisation scheme stopped accepting new applications in 2016, many applications submitted before the deadline are still in process.

We expect that the total supply of commercial properties converted from industrial buildings, including offices, retail and hotels, will increase by 15.9 million sq feet (1.5 million sq meters) when all the projects are completed. The scheme has worked best in areas that have been going through a transformation from industrial clusters to emerging business districts. Some of the successful converted properties are D2 Place in Cheung Sha Wan, Genesis in Wong Chuk Hang and KC100 in Kwai Chung.

However, with only 16% of industrial buildings submitting applications under the revitalisation scheme, the responses fell short of market expectation. In terms of total space, by the end of 2018 only 8.8% of total stock has received approvals and 5.3% of total stocks had completed conversions for non-industrial uses.

Industrial buildings tend to face many limitations when converted for non-industrial uses, including building structure, power limitation, mechanical and electrical system and parking provisions, among other factors. The returns for different uses could also change during the application process, which made some of the initial plans unfeasible when approval was finally granted.

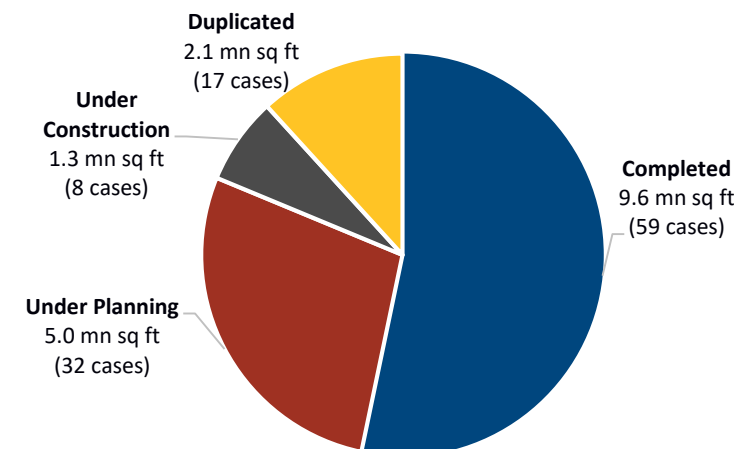
Despite the limitations, the revitalisation scheme has given a second life to many industrial buildings, partly meeting an increasing demand for commercial spaces in Hong Kong.

Number of applications by districts from 2010-2018

Location	Total number of cases received	Total number of cases approved
Hong Kong Island	21	13
Kowloon	125	67
New Territories	80	41
Total	226	121

Source: Lands Department, Colliers International

Application status from 2010-2018



Note: Under planning refers to no progress which can be suspected as speculative application. Duplicated refers to buildings with repeated applications
Source: Lands Department, Building Department, Colliers International

KC100

Case Study

Formerly known as the General Garment Building, the conversion of KC100 into a commercial building with office and retail components was completed in 2015. Located at 100 Kwai Cheong Road in Kwai Chung, and about a 10 to 15 minute walk from Kwai Hing MTR Station, the building provides nine storeys of office accommodation (222,000 sq feet or 20,600 sq meters), two storeys of retail and F&B facilities (62,000 sq feet or 5,800 sq meters) as well as car parking space, an office lobby and street front shops on the ground floor.

Campell Group bought the General Garment Building in 2010 for HKD418 million (USD53.6 million) and revitalised it to Grade A office standards, including retail, for HKD550 million (USD70.5 million)¹. Based on the GFA of 299,030 sq feet (27,781 sq meters), the average cost for revitalisation was HKD1,839 (USD236) per sq feet.

The office spaces are occupied by a diverse group of tenants, such as the banking and finance, information and communications and fashion retail sectors. Based on net floor area, the average net effective rent was between HKD35 - 37 (USD4.5 – 4.7) per sq feet in Q4 2018, comfortably between the net effective rents of Kwai Chung Grade A and B offices, which are at HKD39.5 (USD5.1) and HKD26.1 (USD3.3) per sq feet, respectively.

Retail occupies the bottom two floors, which were converted from three previous industrial floors as the original floor height was too low for retail space. This space is leased to an Italian real estate developer, RDM Asia Limited, for 10 years and is operated as a Florenita Village luxury designer outlet.

At the ground level, the landlord created KC100 Art Space in the office lobby, which has been used for promoting arts and cultural events, as well as bringing new art experiences to visitors and tenants.

To be considered a Grade A calibre office, KC100 had to overcome many restrictions during the planning and construction process, including limitations of on-site parking, external structural demolition, and the loss of GFA due to the conversion of low floors into retail space.



¹ Source: [Ming Pao](#), 18 February 2017

Recap of Scheme 1.0

A GREAT STORY OF ADDED VALUE

While the yield for core office has been compressing in recent years, and investment returns have been largely relying on capital appreciation, industrial building conversions fit the new value-add strategy adopted by many institutional and local investors.

According to the RVD and an analysis of same-district market deals, the average transacted price of revitalised buildings was usually 48.3% above that of industrial buildings, but still 24.1% below Grade A offices in Kowloon.

Selling the building without implementing the refurbishment will not necessarily increase capital values automatically. In 2017, after obtaining government approval in the scheme, Success Centre and Central Industrial Building in Kwai Chung were sold for HKD4,316 (USD553)¹ and HKD4,235 USD543)² per sq feet, respectively, both below the average industrial price at the time.

In addition, revitalised buildings in close proximity to existing business districts or major shopping areas (e.g. Yau Tsim Mong), can achieve a higher capital value especially for those with higher specifications, such as curtain walls, contemporary design, quality materials, and exposure to busy streets.

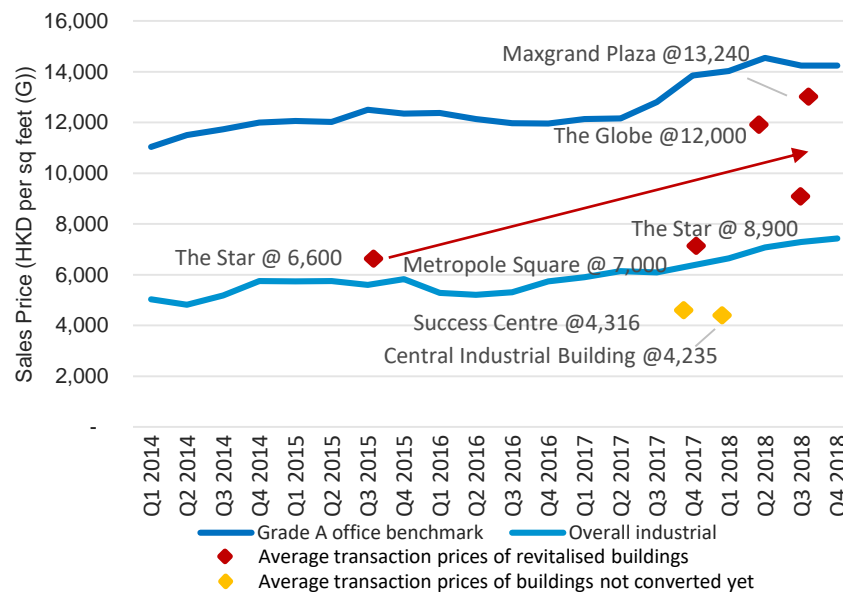
Kwun Tong in Kowloon East has the largest number of the revitalisation applications. Here, for example, the average transaction price for a refurbished industrial buildings is about 24.1% lower than Grade A offices, but 48.3% above industrial buildings.

The strategy that generates the highest return has been the strata sales of smaller units in a fully converted industrial building. Refurbished with contemporary facilities and an improved building specification, the strata title sales transaction price could be as high as a brand new Grade A office building in the same district.

¹ [HKET](#)

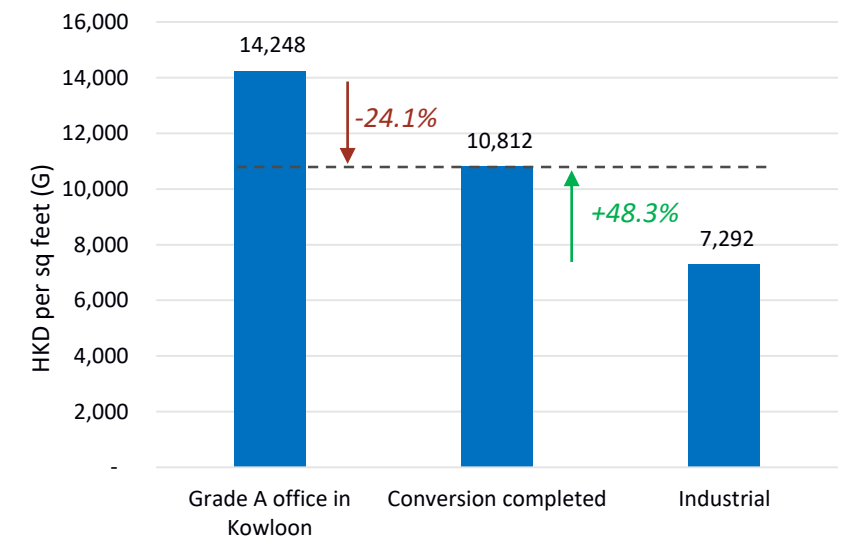
² [HKET](#)

Transacted prices for select buildings



Source: Rating and Valuation Department, Colliers International

Average transacted price comparison



Source: Rating and Valuation Department, Colliers International

Recap of Scheme 1.0: higher returns for investors

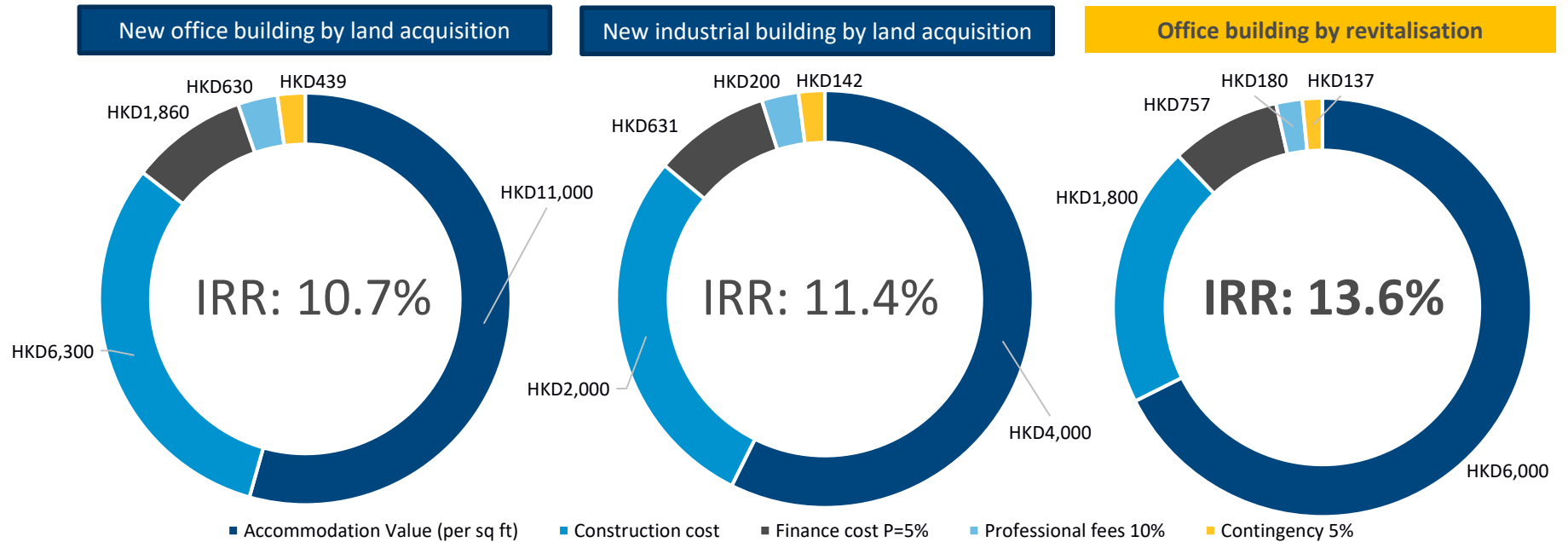
A simple comparison in terms of the internal rate of return (IRR) suggests that acquiring an industrial building and refurbishing it for office use would generate a higher return than building a new office or industrial building from the ground with a 10-year holding period.

In our assessment, we expect the rental and capital value of industrial buildings will increase at a slower rate than office buildings based on historical trends. Our analysis suggests that a refurbished industrial building for office use will generate the highest IRR at 13.6%, compared with the IRRs of 11.4% and 10.7% respectively for developing a new office or a new industrial building through land acquisition.

For new office buildings, high land and construction costs are the main reason leading to a lower IRR. On the other hand, even though the total development cost of new industrial buildings is lower than a revitalised office, the rental rates and capital values would be much less than for a revitalised office.

From an investment perspective, and in comparison to acquiring new land for office development, revitalisation has a comparative advantage of lower land and construction costs, which result in a better return over a brand new office development.

IRR scenario analysis and assumptions



Note: Assumed rental growth of 3% for offices and industrial; assumed price growth of 5% for offices and industrial. HKD figures are per sq foot.
Source: Rating and Valuation Department, Colliers International

Scheme 2.0

WHAT TO LOOK FORWARD TOO?

Ms. Carrie Lam, the Chief Executive of Hong Kong, released her second Policy Address on 10 October 2018, highlighting new policies to tackle the chronic problems of land and housing supply shortage. The Policy Address also highlighted a new revitalisation scheme for industrial buildings. We can see the scheme will likely relax various aspects, such as the GFA on redevelopment, the uses of *godown* as well as transitional housing.


Regarding transitional housing, since the requirements of residential housing are very different from those of industrial buildings, (e.g. kitchens, baths or showers, and latrines among other fixtures, should be provided in domestic buildings) we suspect that not many applicants will actually participate due to high refurbishment costs for conversion from industrial to residential use, unless the minimal rental income is able to justify the investment.

We expect that the relaxation of buffer floor¹ requirements for the

conversion of telecommunications exchanges and data centres and an expanded use of *godowns* will further drive the industrial leasing market. Owing to the high demand for residential sites, development of cleared brownfield sites is probably one of the options that the government will likely adopt. Given that brownfield sites are commonly used for open storage, port back-up facilities, logistics operations and recycling yards, widening the use of *godowns* would allow the operators to move their operations to an industrial building, freeing up the brownfield site for redevelopment.

Moreover, the increasing demand for ICT services, and cloud computing, as well as the robust growth of e-commerce are driving demand for data centres. However, the supply of new data centre sites is very limited and the data centre utilisation rate will likely rise beyond 90% in 2019-2020. Therefore, industrial buildings should be able to undergo partial conversion to data centres to enhance their investment return while increase the supply of data centres.

Summary and comparison of revitalisation scheme 1.0 and 2.0

SAME POLICY	DIFFERENCE POLICY	
<p>For wholesale conversion of industrial should age 15 years or above</p> <p>Industrial buildings should locate in "Commercial" (C), "Other Specified Uses" annotated "Business" (OU(B)) and "Industrial" (I) zones</p> 	<p>1 10% of the floor area for specific uses is prescribed by the government</p> <p>2 For pre-1987 industrial buildings outside "Residential" (R) zone in main urban and new towns, it will be permissible to increase GFA by a maximum of 20% on redevelopment</p> <p>3 (Former) industrial, having completed or will pursue wholesale conversion into non-industrial uses, located in "C", "CDA", "OU(B)" and "R" zones, will be allowed to provide transitional housing in portions or enbloc of the buildings</p>	<p>4 Arts and cultural sectors and creative industries are allowed to operate at individual units without making a separate wavier application and paying wavier fee on a time-limited basis (five years initially)</p> <p>5 Buffer floors will be allowed for telecommunications exchange centres and computer/data processing centres, subject to the safety issue</p> <p>6 The definition for "godown" uses will be widened to cover cargo handling and forwarding operations and recyclable collection centres</p>

Source: 2018 Policy Address, Colliers International

¹ Buffer floors separate non-industrial uses on lower floors from industrial uses located above.

Scheme 2.0

WHERE ARE THE OPPORTUNITIES?

Distribution of industrial buildings by ownership structures and building ages

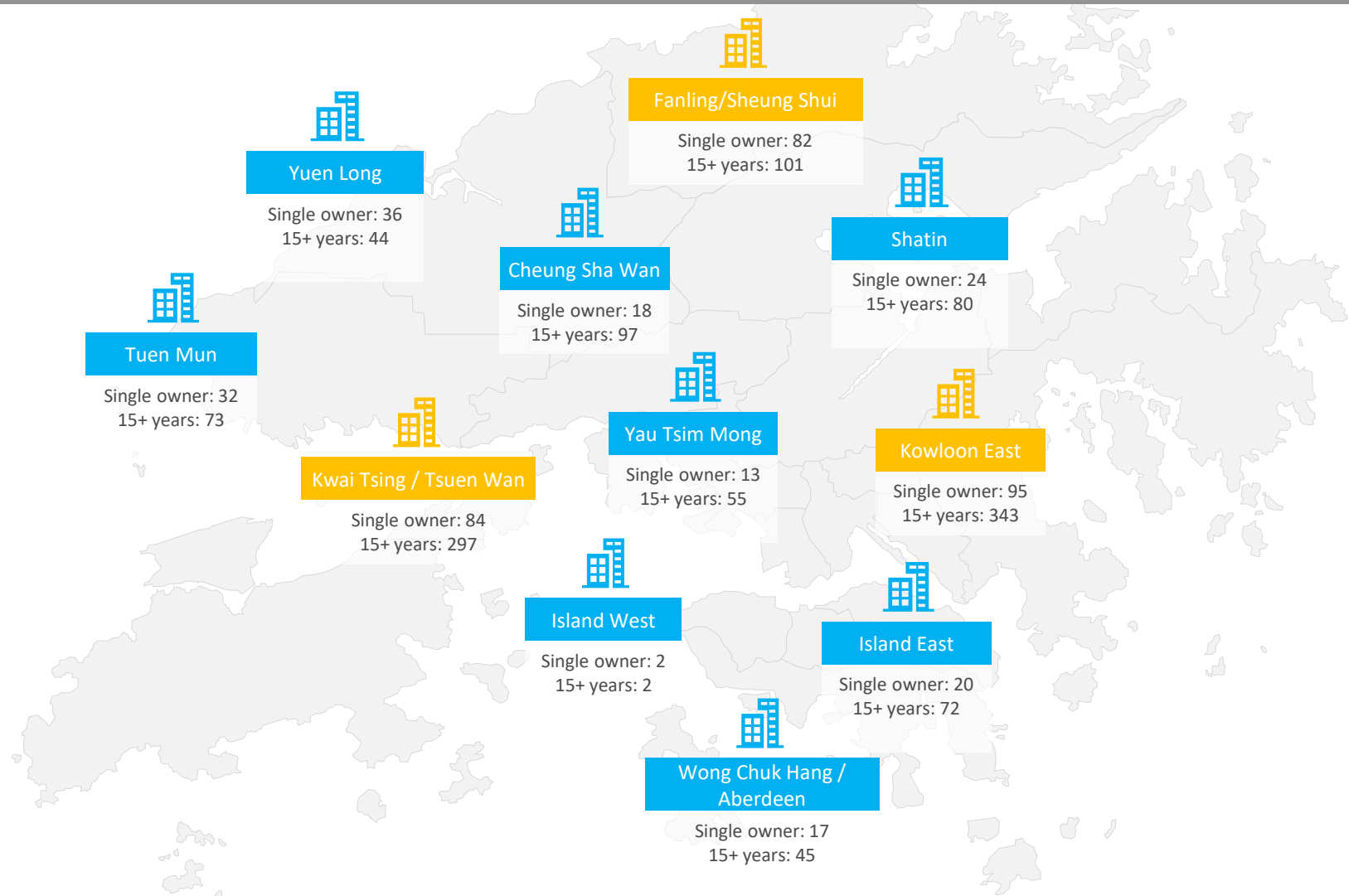
Buildings 15 years old or older, with a single owner, are eligible to apply for the scheme.

Therefore, the greatest number of opportunities exist in:

Fanling/Sheung Shui

Kwai Tsing/Tsuen Wan

Kowloon East



Source: [Report On 2014 Area Assessments of Industrial Land In the Territory](#), Planning Department, Colliers International

Scheme 2.0 THE NEXT HOT SPOTS

In order to determine which district has the most potential under the revitalisation scheme 2.0, we used an exploratory analysis, considering two criteria:

Criterion I: the district's commercial potential

- > The district's accessibility
- > Government policies for development
- > Level of infrastructure development and amenities
- > Potential for growth of residential development and tourism

Criterion II: the number of industrial buildings that are likely to receive approval for the revitalisation scheme 2.0

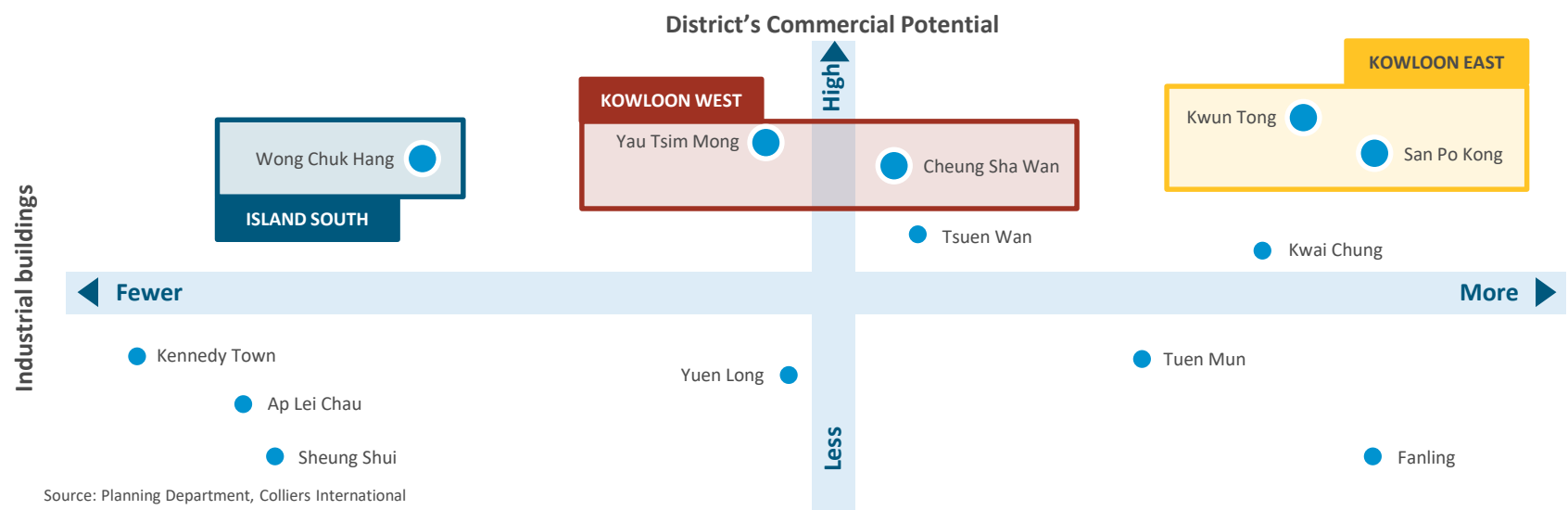
- > Number of industrial buildings in single ownership
- > Number of industrial buildings over 15 years old

According to our exploratory analysis, Kowloon East has the highest potential under the scheme 2.0 due to the number of conversions we expect to be brought about by the development of CBD2, future completion of Shatin-Central Link and the influx of new residents to the district.

Kowloon West, specifically the areas of Yau Tsim Mong and Cheung Sha Wan, also has high commercial potential. As traditional shopping and entertainment areas, tourists and local residents already visit Kowloon West for shopping and other leisure activities. In addition, there are more new residential buildings planned for 2019 and 2020 which should increase demand for retail and office space.

Wong Chuk Hang on Island South also has higher commercial potential due to the area's transformation into a satellite office district. Wong Chuk Hang has become one of the popular options for office relocation on Hong Kong Island. A current lack of business amenities demands further investment in retail and F&B space. However, the number of single-owner industrial buildings are very limited, restricting Wong Chuk Hang's redevelopment potential.

Analysis of commercial potential and industrial buildings



Source: Planning Department, Colliers International

Scheme 2.0

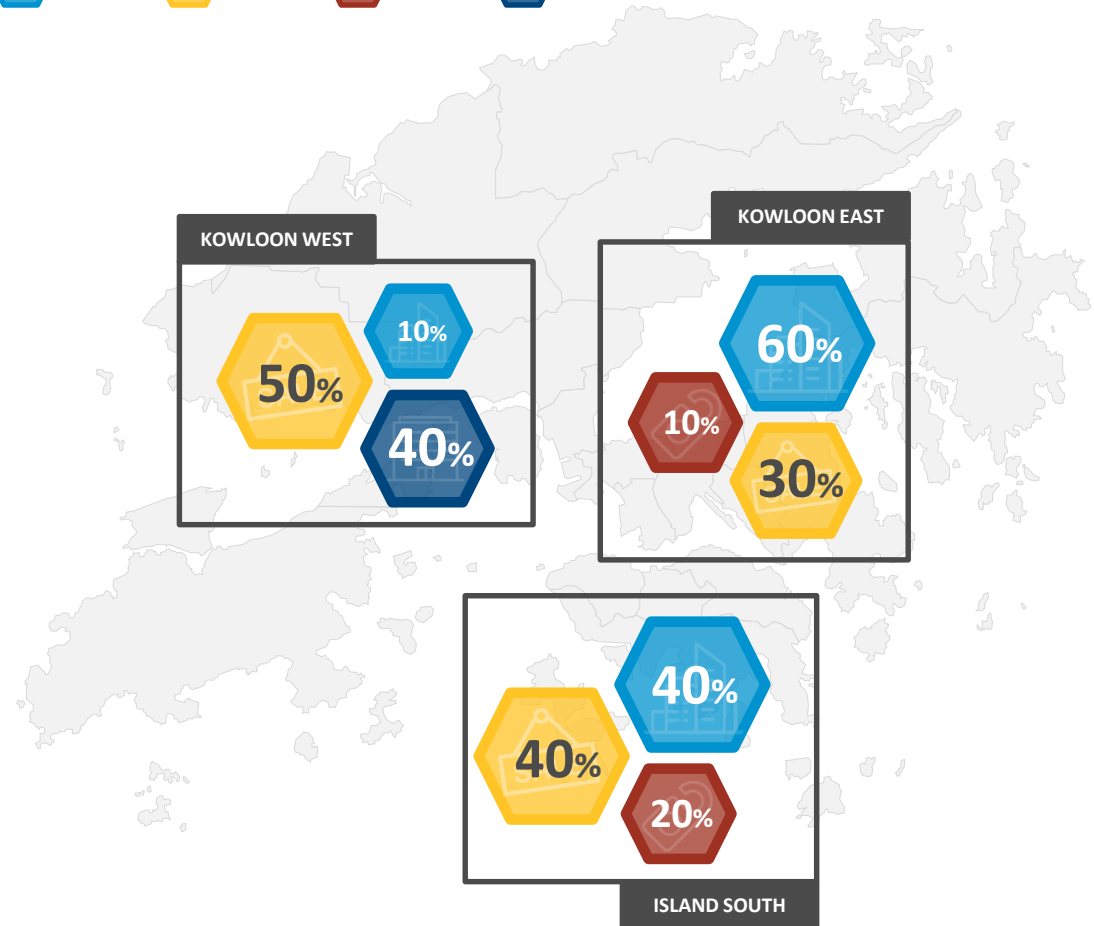
DEVELOPMENT OPTIONS FOR TOP DISTRICTS

Based on current development context and future growth potential, we foresee each of the recommended districts to have a different emphasis for revitalisation.

- > For Island South, the demand for office and retail space should increase significantly with new office and residential developments. We foresee office and retail space will have the strongest demand followed by hotels for revitalisation.
- > Kowloon West will likely be one of the main residential areas in Hong Kong. Therefore, we expect the demand for housing, F&B and leisure amenities to increase, providing an opportunity for the refurbishment of industrial buildings.
- > CBD2 in Kowloon East should continue to benefit from the office relocation momentum and the demand for quality revitalised office space will likely continue to be strong. Hence, office and retail uses would remain the best options for conversion of industrial buildings.

Development recommendation by sectors

 Office
  Retail
  Hotel
  Transitional Housing



Source: Colliers International

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