Room for Growth?
An update on the Hong Kong serviced apartments market
The size of the serviced apartments market in Hong Kong has grown by over 15% in the past three years, with demand largely being driven by expatriate hires in sectors outside of finance and a growing trend of companies favoring the use of mobile and temporary workforce in the region.

Visible demand has shifted from HKD 100,001-140,000 monthly rental bracket to HKD 40,000-80,000 monthly rental bracket.

Demand has largely followed employment shifts in growth sectors, with demand and new supply moving beyond Central to areas such as Hong Kong East and Hunghom.

Sustained demand for serviced apartments has resulted in rents outperforming the top-end of the private residential leasing market.

Converting residential properties into serviced apartments remains one of the most straightforward ways to enter the market, even for inexperienced and small investors.

The availability of professional service providers and small-scale serviced apartment projects is enabling inexperienced investors to enter the market.

We believe the outlook for serviced apartments remains attractive. The growing demand for suites in the mid-to-lower end of the market, however, favors the refurbishment of older buildings. For investors, the growth of the market presents a myriad of opportunities.

In 2009 we published a research paper on the serviced apartments market in Hong Kong, “Serviced apartments – achieving suite success”. Back then, the local economy was just emerging from the depths of the Global Financial Crisis (GFC) and demand for serviced apartments was waning as evidenced by declining rental prices. Fast forward to today and much has changed with serviced apartments having been one of the standout performers in the local property market.

So what is driving growth? What are the key trends that are emerging? How do we see the outlook for this sector? And is there still room for growth? In this follow up paper, we will attempt to shed light on these questions.
A growing market

In the wake of the GFC, investors and developers have remained optimistic on the long term growth prospects for the local serviced apartments market. Back in 2009, we estimated there to be around 14,400 dedicated serviced apartment suites in Hong Kong. Today, the overall figure has grown to approximately 16,800 suites. The greatest amount of stock is still located on Hong Kong Island with overall market share growing from 48% in 2009 to 56% in 2013.

Although stock remains very much concentrated in and around the city’s traditional CBD area, recent years have seen more new projects opening in decentralised districts. Of the approximately 2,700 new suites that have opened on Hong Kong Island since 2009, roughly 70% were opened outside of the CBD area.

The propagation of new suites in these locations has been driven by the growth of the office market outside of Central and the conversion of ordinary hotel suites into serviced apartments – long-stay serviced hotel suites (LSHS). In addition, some modern portfolio-owned residential properties have also been converted into serviced apartments. Some residential units at The Lily – a luxury residential development located in Repulse Bay – for example, were launched for lease as serviced apartments in 2010.
In Kowloon, the market remains largely concentrated in Tsimshatsui and Hunghom with more than 50% of the new suites added since 2009 located in these two districts. These additions, however, were offset by the closure of New World Apartments in 2010, which resulted in a net withdrawal of 522 suites from the market. Many of the new suites that have opened in Kowloon have been purpose-built serviced apartments (PBSA) and LSHS and within easy commute to the Tsimshatsui and emerging Kowloon East office clusters.

In addition to more suites being made available in Tsimshatsui and Hunghom, the market also saw the first serviced apartment project opening in Tsueng Kwan O in 2012. Vega Suites, located above the Tseung Kwan O MTR station, is a new mid-range serviced apartment project positioned with the needs of a growing Kowloon East corporate community in mind.

Of the approximately 3,200 new suites completed in the market since 2009, 83% were what we deem Standard suites – the most utilitarian type of serviced apartment. Boutique suites accounted for 15% of new additions while Prestigious suites accounted for the remaining 2%. In spite of the large number of new Standard suites opening in the market, these additions were offset by the closure of similar quality projects such as New World Apartments and Han Residence, to name but a few. As a result, the overall distribution of serviced apartments, by class, remained largely similar to 2009, with the overall share of Standard suites increasing marginally, from 80% to 83%, tilting towards more competitively priced products outside the CBD area.

In recent years, the market has also seen some consolidation amongst operators. In 2010, Ovolo acquired two serviced apartment projects from rival operator Kush Living while in 2012, CHI Residences acquired Le Rivage from a local operator, only to turn around and sell the project to The Ascott, Singapore-based CapitaLand’s serviced apartment operator division, in May 2013. With larger and more established operators increasing their market share, tenants have enjoyed more standardised offerings across the city, especially in locations further away from the CBD.
What is driving the growth of the market?

The business environment following the GFC has played a key role in shaping the demand for serviced apartments in the city. While the local labor market has remained resilient, with employment reaching all-time highs, growth has been uneven across various industry sectors. The city’s banking and finance sector – one of the largest user groups of serviced apartments – is still in the midst of ‘rightsizing’ with employers keeping a very close eye on operational costs. As a consequence, expatriate hires have slowed and housing budgets have been reduced. Look a little deeper, however, and things aren’t as bad as they might first seem.

Cuts to housing budgets and the growing trend of companies moving employees onto personal leases have resulted in tenants trading down in both the private residential and serviced apartments markets. In many instances, employees are trading down from the luxury segment of the private residential property market into serviced apartments. As a result, we note that the share of requirements for the HKD80,000 or below budget increased from 67% to 73% of total between 2009 and 2013. Meanwhile, the HKD 80,000-140,000 budget requirements shrank from 25% to 20% of total.

The push towards the mid-range and lower-end of the market has also been driven by the growth of industry sectors beyond the financial services sector. In 2009, the banking and finance sector accounted for about 73% of all new leasing requirements in the private residential property market. In 2013, this had fallen to just 54%. The drop-off in demand from the financial services sector has had a big effect on the serviced apartments market because the sector is both the largest source of demand and typically offers its employees relatively larger housing allowances. In contrast, we have seen more requirements from other industry sectors such as retail, education and hospitality, to name a few. This change in the underlying demand has, in part, helped drive the development of the market in areas beyond Central where many of these industries are located.

In Kowloon, the growth of the market has been supported by the steady emergence of the Kowloon East Grade A office market – the total amount of Grade A office floor space under lease increasing by 44% since 2009, or about 3.7 million sq ft. In addition to the overall growth of the office market, there has also been a greater number of foreign companies relocating their offices into the area.

The move by companies towards more mobile and temporary workforce has also had an effect on demand. The flexibility in tenure provided by serviced apartments provides a practical option for employees, especially those seeking employment in Hong Kong for the first time. Companies are also choosing to fly staff around much more rather than hire locally, which is also contributing to the demand for serviced apartments.
The sustained demand for serviced apartments has seen rents grow by about 20% over the past four years to reach all-time highs. Rental performance has closely mirrored demand. While the top-end of the market (Prestigious) has recorded the greatest cumulative rental growth over the past five years, rental growth in the mid-to-lower segment has held up best since the European Sovereign Debt Crisis.

The rental range for serviced apartments is broad, depending on the quality, branding, unit size and location. Prestigious apartments can command monthly rents in the range of HKD 34,500-220,000 while rates for Boutique and Standard apartments – which are typically smaller in size – can range from HKD 20,000-80,000.

The increasing popularity and resilient rental income of Standard and Boutique serviced apartments has led to an improved investment market for small-scale schemes with fewer supporting facilities. Keeping all other factors constant, both Standard and Boutique apartments typically require relatively lower capital investment compared to Prestigious serviced apartment schemes.

For investors looking to get a piece of a growing market, there are a number of channels to participate, including acquiring an asset and running the serviced apartment project independently or using the services of an established chain operator.

Acquisition of enbloc or stratified serviced apartments is the most straightforward strategy to execute. Another common strategy is refurbishment. Of the 37 new dedicated serviced apartment projects launched onto the market since 2009, approximately 30% have been refurbishment projects; converted from older residential or commercial properties.

**Demand shift drawing investors to the market**

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The case for conversion

In our 2009 paper, we outlined the investment case for converting a low quality commercial office building into Boutique serviced apartments. We demonstrated that both the internal rate of return (IRR) and payback period of serviced apartments were typically much more attractive than for low quality commercial offices despite capital investment costs being twice as high. In 2013, the investment case for converting older commercial buildings for serviced apartment use remains valid though an increasing number of investors are opting for hotel conversions instead. For investors, hotel conversions provide the added flexibility of daily rates in addition to providing LSHS.

A drawback of converting commercial properties into serviced apartments is the requirement for government approval to ensure that the premises can be used for “domestic purposes” or the requirements to get a hotel license. Because of this, some investors have shifted their focus onto residential conversions instead - 80% of all refurbishment projects completed since 2009 have been through the conversion of older residential buildings.

A number of parameters need to be considered when assessing the feasibility of a conversion. As a starting point, OPEX as a percentage of gross rental income should not exceed 30%. This is in general the upper limit adopted in most Serviced Apartments projects operated by third party service providers within the market. Thereafter, the feasibility of a conversion depends on the gross rental premium that can be achieved and how much CAPEX is invested. The chart below outlines the thresholds for a financially viable conversion under different OPEX scenario – whereby the conversion of residential units into serviced apartments generates a net rental premium. Areas above the lines represent situations where a conversion would yield a higher net rental premium under the specific OPEX scenario while areas below represent unviable conversion parameters.

While market evidence has shown that it is possible to deliver a twofold increase in gross rental income, the reality is that most conversions typically achieve gross rental premiums of only 60%, at best. At these levels, CAPEX must be tightly controlled, if a net rental premium is to be achieved. Alternatively, investors could improve returns by reducing OPEX or engaging operators that could provide value-added services to boost rental premium. OPEX savings could be achieved through more efficient management, marketing and distribution channels. Top line revenue improvements could also be achieved through value-add offerings, such as transportation, amenities and concierge service arrangements through a third party provider. Operator selection through a more flexible, incentive-based management contract could also lessen the financial risk taken by the owner-investor.

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In 2013, the investment case for converting older commercial buildings for serviced apartment use remains valid.
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Residential Conversion Case Scenario Analysis

Source: JLL
Market outlook

As highlighted in this paper, the most salient and persistent trend going forward is the growth and increasing depth of the demand pool for mid-range serviced apartments. Companies can be expected to remain vigilant on managing operational costs, which will continue to put downward pressure on housing budgets of staff in Hong Kong. With global mobility remaining a key strategic initiative with MNCs, demand for short-term housing is expected to grow. The changing landscape of the financial industry – historically a key driver of demand for mid-to-high-end serviced apartments – will also continue to lead to tenants trading down to the mid-range of the market.

These secular trends will steer demand towards smaller suites typically found in Standard and Boutique serviced apartment schemes. As such, there will not be a need to invest heavily on luxurious fit-outs. These trends will also increase the desirability of small-scale serviced apartment projects, and hence lower the entry barrier for inexperienced investors to the market. Moreover, the trend for investors to package hotel suites as LSHS is expected to continue given the added flexibility of being able to charge daily rates under a hotel operation. Meanwhile, demand is expected to follow the growth of the city’s office market. While Central is likely to remain as biggest market, we expect more suites to open in locations further away from the city’s CBD. Of the 840 additional suites that have already been planned for the next three years, less than 5% will be in Central, and the largest projects will be built in districts such as Quarry Bay and North Point in Hong Kong East and in Tsimshatsui.

The growth of the market beyond Central will be driven by the continuing emergence of the Kowloon East office market, designated as the city’s second CBD, and the continual improvement of Island East as a high quality office hub. Another submarket to watch is West Kowloon, which will be Hong Kong terminus of the new Guangzhou-Shenzhen-Hong Kong Express Rail Link upon completion in 2017.

So is there room for growth? Yes. But the challenge for investors will be to identify properties with value-add opportunities and high rental income uplift potential. Therefore, investors will increasingly need to look for opportunities in new emerging markets in locations beyond Central.
JLL Serviced Apartment Management

JLL offers customised, one-stop integrated services that fulfil our clients’ (investors, developers, tenants and residents) needs. A flexible service menu that caters to our clients’ special requirements is also available. Our team of serviced apartment professionals strive to maximize the potential of our clients’ properties through superior revenue, marketing, leasing, operation and customer services management.

Our advice and services are not only based from our sound knowledge of the serviced apartment industry, but are also culled from the vast insights we have gathered from landlords/corporate/occupants. Managing close to a thousand leases from small hedge funds to large MNCs gives us a wealth of experience and potential clients, not to mention our renowned track record in property management. We have recently won sole appointments for Skyla, The Lily, Residence de Causeway, The Yin and Yi and we are currently working on several other projects as well.

We are the first international property management firm in Hong Kong to receive an ISO accreditation for world-class serviced apartment management.

Our Services

PRE-OPENING CONSULTING SERVICES

Building and Project Consulting Services
- Layout and design review
- Co-ordination of building services, renovation and refurbishment programmes
- Assistance in seeking government approval for serviced apartment conversion
- Fit-out and furnishing
- Property takeover

Marketing
- Market research and analysis
- Product positioning and pricing analysis
- Operating concept development
- Advertising, sales, public relations and promotional activities
- Premium Branding Development

Administration, Human Resources and Procurement
- Organisation, management communications and reporting
- Policy and procedure development
- Recruitment and training
- Provision of procurement services

SERVICED APARTMENT MANAGEMENT OPERATIONAL SERVICES

Operational Services
- Advice on software and IT system for front-office management
- Advice on and implementation of sustainable practices
- Continuous quality assurance to maintain the highest service standards at all times
- Preparation of project master plan
- Preparation of job descriptions and operating manuals for departments
- Preparation of operating budgets
- Preparation of service directory and house rules
- Provision of professional concierge, housekeeping and technical and security services

Operational Technical Services
- Reviews of back-of-house areas and car-park layouts
- Reviews of and feedback on proposed fixture, fittings and equipment
- Reviews and feedback on proposed soft furnishings, finishes, fittings and interior design specifications
- Housekeeping operating equipment and supplies specifications
- Engineering operating equipment and supplies
- Equipment and supplies specifications for a business centre and residents’ club
- Standard provisions/amenities specifications
- Uniform and linen specifications
- Reviews of and feedback on proposed laundry, staff canteen and staff lockers
- Reviews of and advice on technical systems such as security, property management, communication and computer systems

Leasing Management
- Establishment of rentals, fees, leasing terms and preparation of leasing-related documents
- Rental collection, new lettings, tenancy renewal negotiations and rental review

Financial Management and Reporting
- Monthly income, expense statement and projection analysis
- Cash-flow analysis
- Occupants-based analysis
- Outstanding fees analysis
- Recovery of outstanding fees
- Budgeting and budget control
- Inventory management
Denis joined the firm in 2005 and currently leads a team of researchers covering the Hong Kong property market. He has contributed to a variety of research publications and consultancy assignments across China and the broader Asia-Pacific property markets and as a designated spokesperson for the firm, he is a regular commentator on the Greater China property markets. Prior to his current position, Denis helped establish the firm’s research capabilities in the Greater Pearl River Delta and briefly headed the Beijing Research Department.

Mandy has held various roles within Residential team. She spent a few years focusing on tenancy management for residential leasing, responsible for managing a large lease for MNC accounts. Since 2005, Mandy focused on leasing and marketing campaign of sole leasing agency projects for landlords and developers, providing consultancy services to clients on project developments, unit mix, marketing strategies as well as liaison with sub-agents on behalf of the landlords.

Henry is a Regional Director of JLL. He is a key member of the Capital Markets Team in Hong Kong, encompassing Investment sales as well as residential sales, marketing and strategic consultancy. He joined the firm in July 1999 with Residential Department, and his main role is to coordinate on day to day sales & marketing of residential properties, conducting research on residential market.

Cathie joined JLL in 2008 and she is currently the Local Director of the Research Department. Cathie takes on a crucial role in developing and executing the Firm’s research consultancy business. Cathie is an expert in providing clients with professional advice on real estate project feasibility, optimum development mix and generic-market research studies for a wide spectrum of real estate sectors in Hong Kong, Macau and other cities within the Pearl River Delta region. Her clientele includes property developers, fund managers, investment bankers and other government/semi-government organisations.