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The changing Bengaluru office market dynamics

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Bengaluru, the Silicon Valley of India, is one of the fastest-growing and top-performing office markets in India. In the long term, we expect Bengaluru to retain its pivotal position of a 'Technology Hub' in the country since the talent pool offered by Bengaluru is unequalled by any other city. However, we expect the city's office market dynamics to change over time in terms of 1) location preferences, 2) workspace design and 3) occupier profile. We also think that the fast-growing neighbour Hyderabad can no longer be ignored and that Bengaluru may lose some market share in office leasing to Hyderabad. However, this is only likely to happen if Hyderabad maintains the momentum of new supply additions over the next three years. We see rising rents, supply crunch, technology disruption, the spread of flexible office space and infrastructure related issues as the key factors that will drive office dynamics in Bengaluru in the coming years.

Over the past two decades, Bengaluru (Bangalore) has witnessed unprecedented growth and has gained the status of the 'Silicon Valley' of India. The city has seen huge urbanisation and the increasing presence of technology groups and Global In-House companies (GICs, i.e. offshore centres that perform designated functions for large organisations). Consequently, the city's office built space has increased by more than 100% in the past decade. Currently, Bengaluru accounts for about 25% of India's total Grade A office inventory. However, this remarkable growth has come at the cost of unplanned urbanisation and created massive pressure on existing infrastructure. In our opinion, although Bengaluru's office market landscape is studded with the presence of major technology companies and start-ups, the rising rents, supply crunch, technology disruption, the emergence of flexible office space and infrastructure will remain key concerns in coming years. In this report, we have analysed the top five trends that have the potential to alter the Bengaluru office market dynamics.

Trend 1: Bengaluru to retain No. 1 position, but Hyderabad can not be ignored

Bengaluru ranks unquestionably as the no.1 market by office demand in India. In our estimate, Bengaluru has maintained its leadership position by taking a lion's share of about one-third of total India gross office absorption over the last five years. In 2017, Bengaluru's demand for Grade A office space reached 15.3 million sq ft (1.4 million sq m), accounting for 36% of India's office transaction volume.

Figure 1 - Ranking of Indian cities based on gross absorption

Rank	2015		2016		2017	
1	Bengaluru	30%	Bengaluru	31%	Bengaluru	36%
2	NCR	20%	NCR	18%	NCR	18%
3	Mumbai	15%	Mumbai	13%	Hyderabad	14%
4	Chennai	11%	Hyderabad	13%	Mumbai	11%
5	Pune	11%	Chennai	13%	Chennai	11%
6	Hyderabad	10%	Pune	9%	Pune	8%
7	Kolkata	2%	Kolkata	2%	Kolkata	2%

Source: Colliers International India Research
*% of total gross absorption

We anticipate that Bengaluru will remain the preferred office market due to its large talent pool. However, looking at the growth pattern of Hyderabad, we think Bengaluru may lose some of its share to its fast-emerging neighbour.

Within the last three years, Hyderabad has jumped from sixth to third position by gross absorption among the top seven Indian cities. In 2017, with 5.8 million sq ft (0.5 million sq m) of gross absorption, Hyderabad accounted for 13% of the total office absorption, exceeding Mumbai, the financial capital of India (please refer Figure 1).

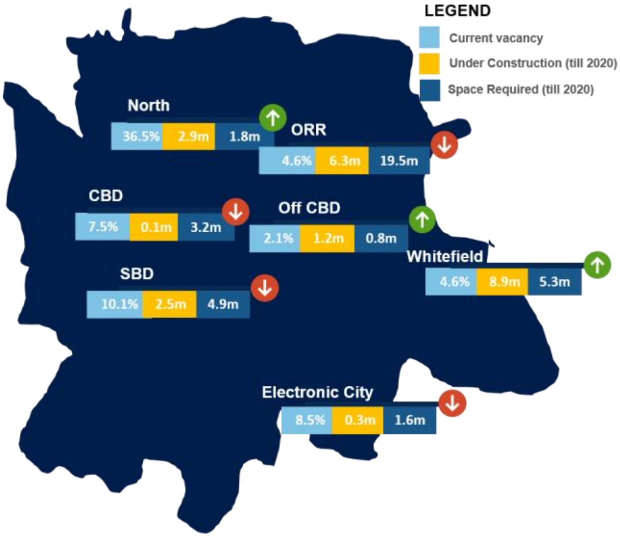
In our opinion, the factors working in favour of Hyderabad are its cheaper rents, occupier-friendly state government policies and robust supply pipeline. The average Grade A rent per sq ft per month in Hyderabad INR43 (/USD0.7) is about 40% cheaper than Bengaluru's average Grade A rent of INR72 (USD1.1). We forecast that average rents in Bengaluru will rise by 10-15% by 2020, whereas Hyderabad's rents will increase by a mere 2-5% over the next three years. Thus, Hyderabad ought to attract cost-conscious occupiers. Also, based on our forecast, demand is likely to outstrip supply in the next three years in Bengaluru which may force some companies to consider Hyderabad. However, this will depend on the timely completion of projects under construction in Hyderabad, which itself has single digit vacancy levels of 6%. Based on our estimate, Hyderabad has about 30 million sq ft (2.79 million sq m) of new supply pipeline scheduled for completion by 2020.

Trend 2: Location dynamics likely to change as demand set to outstrip supply

We expect the location dynamics within Bengaluru to change over time. Currently, the Outer Ring Road (ORR) is the preferred micromarket in Bengaluru with an average share of 45% of total leasing volume over the last three years. The Secondary Business District (SBD) and Central Business District (CBD) are the second most popular locations, with average shares of 12% and 9% respectively.

By 2020, the new supply of 27.5 million sq ft (2.5 million sq m) is likely to get added in Bengaluru's Grade A inventory. The epicentre of the upcoming supply is Whitefield with around 36% share, followed by ORR (26%), North (12%). The rest of the supply is shared equally by all other micromarkets.

Figure 2: Demand - Supply dynamics



Source: Colliers International India Research

On closely analysing the demand-supply dynamics (please refer Figure 2), we conclude that the upcoming demand is likely to outstrip the forthcoming supply in most of the popular locations such as ORR, CBD, SBD and Electronic City. This may spur occupiers to shift to other micromarkets with surplus supply such as Whitefield and North Bengaluru. Moreover, once the construction of the Metro rail starts in ORR, occupiers interest in the micromarket may be temporarily reduced due to expected traffic congestion in the same way that Whitefield is experiencing congestion after the start of the metro rail construction. Whitefield's metro rail construction is picking up and is scheduled to be completes by 2020, so the micromarket should gain prominence by then.

Considering the past trends, Bengaluru will require about 35-40 million sq ft (3.2-3.7 million sq m) of new space to sustain the upcoming demand by 2020. However, the supply pipeline is projected at 27.5 million sq ft (2.5 million sq m).

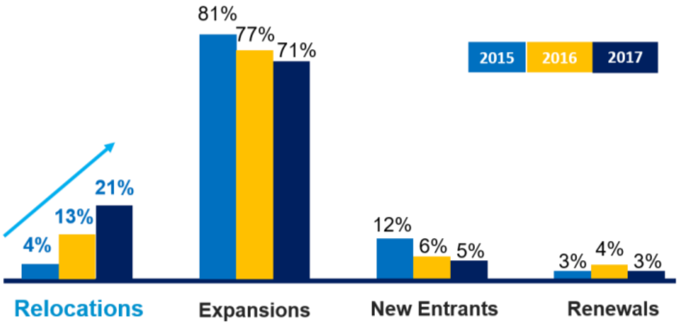
We therefore cannot rule out the possibility of a shift of occupier interest towards other neighbouring markets. In this case, occupiers may have the option to choose among Chennai, Hyderabad and nearby Tier II cities such as Coimbatore, Vijayawada and Kochi. In our opinion, Hyderabad is likely to be the preferred option among occupiers due to the uncertain political environment in Chennai and talent pool crunch in Tier II cities.

The general occupier opinion is that due to availability of a vast talent pool, Bengaluru is irreplaceable by any other city. This trend is also supported by Colliers Asia Pacific (APAC) survey report 'Tech Trends in Asia' dated 5th December 2017. According to the report, acquisition of talent is the single greatest challenge faced by the technology occupiers, ranking far ahead of other constraints. The report demonstrates that the enterprises in the study have particular respect for the technology education and technology ecosystem in China and India, with Beijing ranking first in this respect among Asian urban centres, followed by Shanghai and Bengaluru.

Trend 3: More consolidation and relocation likely in the short to medium term

Over the last three years, while expansion has remained the primary driver of Bengaluru's high office space absorption, we have observed that the share of relocation in overall demand has been increasing at a fast pace. Since 2015, we have noticed that the share of new entrants has also declined consistently.
From the Colliers Research database, an average of 76% of the total leasing transactions recorded over the last three years represented expansions primarily by technology and BFSI occupiers.

Figure 3: Trend of Relocation and Expansion



Source: Colliers International India Research

However, companies were also consolidating and relocating in order to be more efficient and cost-effective. We have traced a surge in relocation moves as a proportion of transactions from 4% in 2015 to 21% in 2017 over the past three years (please refer to Figure 3).

We expect the trend of increasing relocation and consolidation moves to continue in the short to medium term. The factors that are likely to drive the trend are:

High rents: We project that the current average rent of INR72.0/sq ft/month (USD1.1) will increase by 10-15% in total over the next three years

Supply crunch: A dearth of new supply in preferred locations is likely to push occupiers to look for alternative locations

Quest for space efficiency: to fulfil the need of collaborative and efficient workspace, occupiers may have to consider relocation

Trend 4: Flexible office space likely to grow faster than anticipated

Demand for flexible workspace (coworking space and serviced offices) has been rising very rapidly in India since 2015. Bengaluru, the home to about 51%[1] of start-up companies related to the Internet of Things (IoT) in India, is the pioneer of flexible working space in the country. Recently, global leaders in flexible office space, including WeWork and Regus, have led the way forward in this market and leased substantial office space (above 40,000 sq ft or 3,717 sq m in 2017).

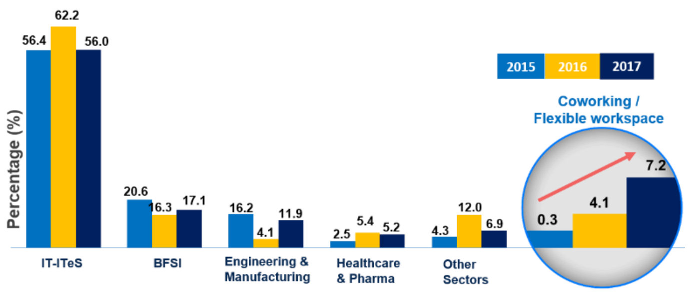
We expect these large players to compete against traditional offices by targeting major corporates, besides serving small and medium enterprises. In our opinion, this trend started picking up in 2017 with multinational corporations (MNCs) such as Amazon, Microsoft, Ernst & Young and Snapdeal occupying large areas of office space in flexible working centres in Bengaluru.

Looking at the increasing interest of occupiers in flexible workspace, developers have started exploring this emerging sector. CoWorks started by Bengaluru-based developer RMZ has rolled out flexible work-space in its portfolio and opened several coworking spaces in its own buildings by investing in modern technologies for tenants hired across India.

Thus, we expect flexible office space to continue flourishing in the coming years. Factors such as low capital and operational expenditure, minimum lock-in period, the opportunity to network and collaborate, scope for expansion and flexibility will further fuel the growth of flexible working operators in Bengaluru in coming years. Moreover, flexible workspace sites are mostly strategically located in CBD and SBD areas that have established road, metro rail and social infrastructure.

Moreover, according to our APAC survey report ['Tech Trends in Asia'] dated 5th December 2017, in order to attract and retain high talent, technology companies should move towards CBD or CBD fringe areas, or business parks on city outskirts for smaller companies; in our opinion, out-of-town campus sites are unlikely to attract the talent required to succeed in the future. In Bengaluru, most of the flexible workspace sites are located in the CBD and SBD areas. This should attract the occupiers focusing on talent retention.

Figure 4: Occupier composition trend



Source: Colliers International India Research

Trend 5: Change in the profile of occupiers

Micro-level analysis of occupier composition in the last three years suggests that, while IT-ITeS occupiers continue dominating the office leasing landscape in Bengaluru, changes are happening in the profile of other occupiers. Over 2017, there has been an increase in the share of e-commerce and fintech companies within IT-ITeS and BFSI sectors respectively. The share of logistics and manufacturing also increased in 2017.

[1] As per the "IoT Start-up Directory 2017" by India Electronics and Semiconductor Association (IESA) and The Indus Entrepreneurs (TiE), Bengaluru

In our opinion, policy initiatives such as Make in India, Skill India, uniform Goods and Services Tax (GST) and relaxed Foreign Direct Investment (FDI) norms should further drive the growth of manufacturing and logistics sector. At the same time, the Digital India and Start-up India campaigns should drive the establishment of more fintech and start-up companies. We expect this trend to continue and drive the change in occupier composition in the medium term.

Colliers View

Regardless of the changes in office market dynamics mentioned above, Bengaluru's commercial real estate is likely to remain robust over the next three years. Although we cannot ignore the growing prominence of Hyderabad, the availability of a large talent pool and the large footprint of global companies should help Bengaluru maintain its pivotal position in the India office market. In our opinion, considering Bengaluru's reputation as ‘Silicon Valley of India', new entrants should choose Bengaluru for their front office requirements.

On the basis of our discussions with market participants, the general opinion of occupiers is that Bengaluru cannot be replaced by any other city in India as a source of talent. Thus, occupiers with specific talent pool requirements should continue expanding in Bengaluru. However, looking at the rising rents and the supply crunch in Bengaluru, cost cautious occupiers should start exploring Hyderabad for their backend operations.

Colliers Research makes the following recommendations to the government, developers and occupiers to ensure that Bengaluru maintains momentum over the long term.

Streamlining of policies: Implementation of consistent and robust policy framework will boost investor confidence in Bengaluru market. We suggest that the state government should streamline polices related to restrictions on lake development, Transit Oriented Development (TOD) and the Bengaluru Development Plan (DP) on a priority basis to ensure the growth momentum of the city.

Collaborative Efforts: We also recommend the state government to encourage developers and occupiers to take part in infrastructure developments in their areas of interest by making such developments an element of Corporate Social Responsibility (CSR)

Redesign for Future: We advise landlords to recognise the benefits of flexible workspace and redesign office space across their portfolios. Landlords and developers should focus on maximising opportunities by utilising underused spaces to address the supply crunch in the city. Landlords can also redesign their existing space to create collaborative workspace to meet the needs of smaller tenants – from whom we are currently seeing strong demand. Landlords should look to offer quality and more efficient office space through subdividing floors into multiple office suites

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