# Real Estate Outlook

Asia Pacific – Edition 1, 2020

Stay invested.

UBS

UBS Asset Management

# APAC offers diverse opportunities come rain or shine.

**Toh Shaowei**
Head of Real Estate Research
& Strategy – Asia Pacific

Fiscal responses to augment existing accommodative monetary stances. Occupier performance is mixed and highly dependent on supply given muted demand dynamics. Market participants are taking longer to evaluate transactions amidst diverging price expectations. 2020 is likely to still see marginal cap rate compression in the commercial real estate space.

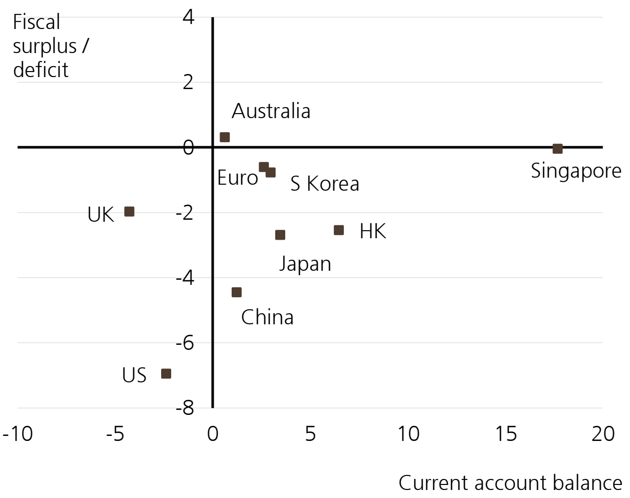
# APAC outlook

## Real estate fundamentals

**Keep your chin up**
2019 ended on a better note than it had been playing out for most of the year. A raft of encouraging news looks to be an indication of better times to come, particularly after a rough period for most Asia economies. The recently concluded "Phase-One" trade deal between China and the US has almost immediately led to upward revisions of economic forecasts for 2020. To be clear, Asia is not out of the woods yet, as the full impact of a hiatus in the ongoing trade dispute will not be felt in entirety just yet. Also, there is a high level of uncertainty around the coronavirus outbreak, which has seen global movement of people, services and goods being impacted.

As we look around the region, there are ample reasons for market participants to keep their chins up, even as the external environment remains challenging. There is significant fiscal stimulus headroom for most developed Asia governments (see Figure 1). Current account balances are relatively stable, and there is still scope for further increases in fiscal deficits to fund long-term investments into infrastructure and social programs. The expansionary fiscal stance adopted by many Asian governments should provide much needed tailwinds for investment, employment and domestic consumption.

**Figure 1: Current account and fiscal balance estimates** (% of 2019 GDP)




Source: Oxford Economics, CEIC, 4Q19

Besides supportive fiscal drivers, a concurrent theme in 2019 was the willingness of central banks to flick the monetary easing switch (rather frequently) in some Asian economies. The People's Bank of China announced a 50 bps cut in the required reserve ratio (RRR) for banks on the first day of January 2020, which is estimated to release RMB 800 billion of liquidity into the economy. 2019 had already seen at least three such similar cuts in the RRR, on top of a lowering of the seven-day repurchase rate, the first such easing since 2015. Down under, the Reserve Bank of Australia embarked on three reductions in the cash rate in the span of five months, bringing it down to a historic low. South Korea's central bank also responded with two rate cuts in July and October. Besieged by domestic and external pressures, Hong Kong reduced its base lending rate three times in 2019, moving in lockstep with the US Fed.

Are the recent monetary easing actions symptomatic as to the dire state of the regional economy – and requiring drastic reactions – almost akin to scrapping the bottom of the monetary policy barrel? Or, do these accommodative monetary responses demonstrate the resolute resilience of APAC economies in the face of adversity? Either way, the lower for longer interest rate scenario seems to be here to stay in the next year at least, and that has significant influence on capital flows and investment behavior in APAC real estate markets.

**Retail**
Retail sales in most of Asia have mirrored languid consumer sentiments, not just in the last quarter of 2019, but arguably since late 2018. Wage growth, or rather the lack of, has definitely been a key reason behind the tightening of purse strings. In markets such as Australia and Singapore, diminishing wealth effects arising from the slowdown in the housing sector have become more obvious. To make things worse, tourist spending has become more muted. In some markets, geopolitical tensions have affected absolute tourist arrivals numbers; in other markets, we have observed a change in traveler habits steering tourism expenditure towards services. And the above discussion has not even included the well documented fact that ecommerce penetration continues to increase every day, chipping away at physical retail's share of the consumer wallet.

In the last months of 2019, headlines were focused on Hong Kong, in particular the plunge in retail sales due to a sharp drop in tourist numbers. China's "Golden Week" holiday in October did not translate into a tourism bonanza for Hong Kong, as mainland Chinese tourists diverted their holidays elsewhere. Compared to the same month in 2018, visitor arrivals in October 2019 plunged by more than 40%. Periodic episodes of social unrest have also dampened the festive mood, keeping many local shoppers off the streets in the last three months of 2019. To that end, prime high street retail rents fell 9.7% YoY in the last quarter of 2019.

Some say the business of retail operations is a more an art than a science. Cynics will offer their two cents' worth, adding that art does not pay for many struggling artists. To some extent, this is true of the state of retail in most of Asia. Along the prime retail strips and high streets, we continue to see major retail tenants willing to take on higher rents in exchange for brand presence, shopper footfall and spending. We observe this in Tokyo, Osaka, Sydney and Melbourne, where landlords of prime retail continue to play the role of price setters. In less dominant retail assets, or in shopping malls that do not have the same catchment advantage as prime retail, it certainly is an art for operators to reposition their retail offerings to draw in the crowds. The oft-mentioned strategies include omni-channel retailing, creating more experiential attractions, and setting aside more F&B options, amongst others. While these are all useful, the real art is in the delicate balancing of economic interests with associated costs of these new retail strategies. And, only some landlords will be able to sculpt the shape of their retail performance better than others.

**Industrial**

The slowdown in manufacturing and trade-related activities has manifested into weaker occupier demand from industrialists, primarily driven by ambiguity around how much longevity the trade dispute might have. Industrial PMIs for goods have trended lower, and have even dipped into contractionary territory in some markets. However we have not seen entire supply chains migrate to Southeast Asia, as was widely anticipated, and much of the high value-add production remains rooted in developed Asia.

Even before the recent cycle, investors have turned their attention towards warehousing and logistics – minimizing direct exposure to manufacturing – focusing on domestic demand and supply chain efficiencies. However, supply risks remain tilted to the downside in some markets where speculative completions have been high over the last few years. In Tokyo, while demand was strong, the supply of inland logistics facilities neutralized much of the rent growth. In contrast, while the stock of logistics facilities in the Tokyo Bay area is ageing, location and the lack of new supply supported rental growth in 4Q19. In China, the lower tier cities struggle with high levels of completions that will take a long time to digest. The restrictions on industrial land supply has become more obvious recently, and that should help to stabilize the occupier markets going forward.

Rents in Sydney and Melbourne rose 1.5% and 2.1% YoY, respectively. The supply of industrial land is increasingly limited, given that significant stock of industrial land has been re-zoned for alternate uses and infrastructure-related requirements. This imbalance is reflected by a notable rise in rents and industrial land values. In Singapore, the oversupply situation has improved considerably and in some sub-segments, such as business parks, rents and occupancy have seen positive reversions. In the absence of any new known pipeline, the underlying demand for high quality industrial space is supportive of the business park segment in Singapore.

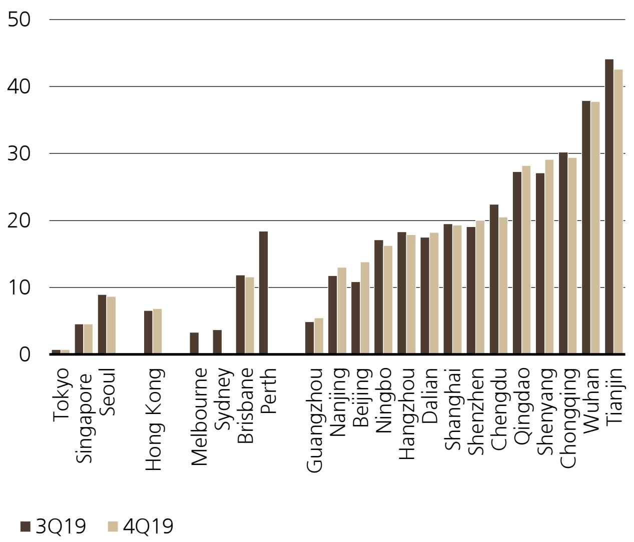
**Office**

Performance in the office sector remained mixed in the last quarter of 2019. While economic fundaments appear to be softening, leasing demand has been generally stable across most key office markets. The services sector has risen to the occasion, and tenant demand from the technology and media sector helped offset the corresponding pullback from the manufacturing and finance industries. Flexible office operators have been a mainstay of tenant demand in most Asian markets, and this trend looks set to stay.

The Tokyo office market has pleasantly surprised in spite of the higher levels of completions in the last two years. There are a few reasons for this. Japan Inc. has held up relatively well in the face of falling external demand and many corporates continue to sit on huge cash reserves. Landlords are mostly financially strong and are not motivated to reduce headline rents. As such, Grade A office rents have stayed firm and vacancy rates remained low (see Figure 2). What many observers neglected to factor in – however – was the recent change in labor laws that indirectly increased the requirements in employee headcount and office space by Japanese companies. Coming into force in April 2019, the legal cap on work hours resulted in companies plugging the gap by hiring more workers, which in part led to expansions and higher demand for office space. All these factors combined ensure that the Tokyo office market remains balanced at the start of 2020.

**Figure 2: APAC CBD office vacancy rates**

(% of existing stock)



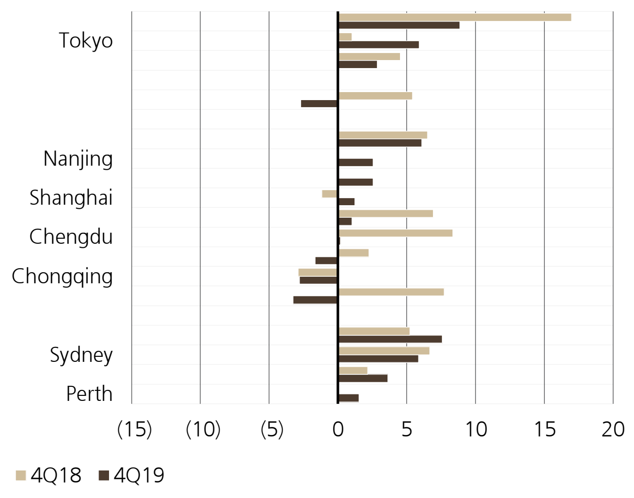

Source: CBRE, 4Q19. Latest Sydney, Melbourne and Perth data as at 3Q19

In Hong Kong, the office leasing market continues to feel the chills from the double whammy of the US-China trade dispute as well as ongoing social unrest. Greater Central rents fell 2.7% QoQ, the greatest quarterly decline since 2012. Anecdotal feedback suggests that many corporates have ceased their expansion plans and lease renewals have generally taken a backseat. Enquiries from Chinese companies have largely evaporated, and that is significant for office absorption in Central given the reliance on this tenant group in the last few years.

Following an unspectacular 4Q19, rent growth prospects in Beijing and Shanghai are amongst the dullest in Asia.
In Beijing, the influx of new office supply in the core CBD at Guomao and decentralized locations underpins our weak rent outlook. Shanghai faces the same supply-side pressures as Beijing, but we are likely to see that taper off gradually in 2020 and onwards. In many lower-tier cities, the vacancy rates continued to inch up, with some cities coming in at more than 30%. In Singapore, limited new stock resulted in Grade A Core CBD rents rising 6.9% YoY (see Figure 3). Main leasing activities have been focused on consolidation of office space and a general flight to quality. Purely from the supply side of the equation, the next wave of completions will occur post-2021, which is supportive of near-term rents and occupancy.

The Sydney and Melbourne office markets are displaying mid to late cycle characteristics albeit with a rather long tail. While demand has been firm, the dearth in net office supply has been the driving force behind solid rental performance in the last three years. In 4Q19, on expectations of the pick-up in new completions, rent performance was normalizing but remained positive. In resource markets such as Brisbane and Perth, the inventory overhang will continue to be a drag on the overall leasing market, although that may not necessarily be the case at the asset-specific level. We remain selective in Brisbane and Perth.-specific level. We remain selective in Brisbane and Perth.

**Figure 3: APAC CBD prime office rent growth**
(% YoY)




Source: CBRE, 4Q19

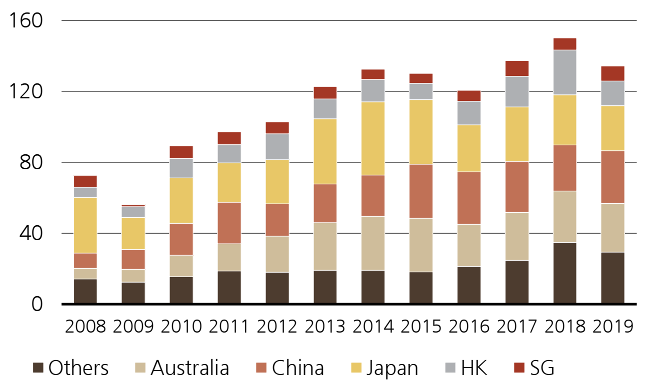
# Capital markets

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property dropped by approximately 11% YoY in 2019 (see Figure 4). Against the uncertain economic backdrop, market participants are taking a longer time to evaluate transactions, and the disparity in expectations between buyers and sellers diverged further as interest rates started reversing downwards across the region. This was one of the key reasons for the fall in transaction volumes in 2019.

On the market-level, Hong Kong saw the biggest absolute and YoY decline in investment volumes in 2019. From a high of more than USD 25 billion in 2018, commercial investment volumes fell to around USD 13.8 billion in 2019, a significant 45% fall YoY. The last quarter of 2019 also marked the lowest quarterly investment volumes since 2009. This can hardly be described as surprising, given the upheaval experienced in the second half of 2019. We do not expect any major knee jerk reaction by owners in the form of distressed sales, nor do we believe that cap rates will decompress significantly. A lack of supply in the Central area continues to underpin our thesis that, in the absence of any full-fledged and adverse response by China, prime office market values will continue to hold up, at least going into 2020.

A clear juxtaposition of contrasting fortunes can be found in the Singapore investment market. In terms of absolute transaction figures, Singapore's smaller market size naturally leads to lower activity than other Asian markets, coming in at approximately USD 8.3 billion for 2019. However that is a marked increase of 21% from the year before. The scarcity of available assets as well as the high valuations are two factors that have prevented investors from transacting more in Singapore. Anecdotal evidence suggest that investors are willing to take a longer-term view of the market and tolerate slightly tighter entry cap rates, in exchange for stability and capital preservation.

**Figure 4: Commercial real estate transaction volumes**
(USD billion)




Source: RCA, as at 31 December 2019

China still makes up the bulk of APAC commercial real estate transaction activity. On a YoY basis, transaction volumes increased by approximately 15%, which in the greater scheme of things, is clearly better than most peers in Asia. Foreign institutional and sovereign capital remain positive on the prospects for China's commercial markets. Japan and Australia saw almost 10% and 6.0% YoY falls in transaction volumes, respectively. Australia's investment market made a final push towards the end of 2019, as two major office assets in Sydney changed hands, as well as a retail mall in Adelaide.
In particular, the transacted price of the mall was highly watched as it was likely to set a guidance for the valuations of other similar retail malls in Australia. At a discount of only less than 3% to valuation, it appears that investors still have confidence in the retail segment, especially for those assets displaying characteristics of dominance.

2020 is likely to see marginal cap rate compression in the commercial real estate space, for a few reasons. One, the low interest rate environment (increasingly so in many APAC markets) has intensified downward pressures on yields with investors especially looking towards real assets for returns. Two, the dry powder already allocated to Asia private equity real estate remains significant. Also, the growing fiscal burden of deteriorating demographics across the globe is hastening the search for higher-yielding income producing investments. This is unchanged from what we observed over the past few years, with the subtle difference being an ostensible urgency to deploy into real estate.

# Strategy viewpoint

At time of writing, Asian markets have ushered in the year of the Rat, marking the beginning of another 12-year zodiac cycle. In the Chinese zodiac, the Rat is ranked first, but not without reason. Folklore has it that the ancient race to determine the zodiac sequencing saw the Rat jump into the Ox's ear and take a ride towards the finishing line, where it then stole a lead on the other animals. Such is the intelligence, flexibility and focus displayed by the Rat. And in 2020, we believe that investors should similarly adopt a playbook based on the same tenets, albeit with an added focus on risk mitigation.

The final months of 2019 saw some form of resolution in the ongoing US-China trade dispute. It appears unlikely that a V-shaped recovery will take place even with greater geopolitical clarity unless there is a full roll-back of tariffs, new and old. We remain in a risk-on mode, on the back of existing concerns over the maturing technology cycle, upcoming elections in the US, as well as the ongoing structural slowdown in the Chinese economy.

The last point is particularly important, as the regionalization of the Asia economy has led to greater reliance on the Chinese economy, and thus indirectly affecting commercial real estate markets in Asia. That said, as the adage goes, burn not your house to fright the mouse. We have to be aware of the downside macro risks in 2020, but there is no need for real estate investors to over-react. The intelligent, nimble and focused investor should look beyond immediate economic cycles and turn their attention towards sub-markets and asset selection in key Asia markets.

In markets such as the office sectors in Singapore, Sydney, and Melbourne, where near-term supply conditions are still constrained, occupier performance continues to run ahead of the economy. As core pricing stays elevated, the intelligent investor may wish to be flexible in sourcing for under-managed assets and focus on driving income reversion.
In Australian markets, long-lease structures present opportunities for buyers of selective office assets to still benefit from reversionary upside, even if market rents are normalizing. The nimble investor can also look towards regional markets such as Brisbane. In regional markets, the focus should be on acquiring high quality assets that still offer some pricing advantage over primary markets.

In the retail sector, there has already been a general re-rating outside of Asia. The intelligent investor should be able to cut through the noise and focus on resilient retail asset attributes. The truth is that urban layouts in most Asian cities are supportive of retail, and to some extent we do not expect a total meltdown in the sector. The nimble investor should keep an eye open for retail assets that have seen some capital value adjustments but offer significant scope to buy and fix.
There has to be a laser sharp focus on executing asset and tenant mix enhancement to drive footfall and spending.

We saw the Japanese economy hobble along unspectacularly over the past year, but that should not detract from the relative appeal of metropolitan cities such as Tokyo and Osaka, where we see the effects of centralization supporting the commercial real estate and multi-family sectors. Looking beyond nationwide demographic pressures, the intelligent investor will be able to identify structural themes that are constructive for investing, such as population growth on a regional basis. Core sectors face tremendous competition from the Japan REITs, and the nimble investor will explore value-add and develop-to-core strategies, focusing on boosting incremental intrinsic value while looking towards REITs as key exit channels.

In the year ahead, investors should continue to deploy into Asian markets but are advised to stick close to investments that feature high quality assets, strong locational attributes, and for riskier strategies, well defined partnerships with established local players.

**Our research team**
Adeline CHAN
Christopher DEBERRY
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Samantha HARTWELL
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
William HUGHES
Sean RYMELL
Shaowei TOH

For more information, please contact:

**UBS Asset Management**
Real Estate & Private Markets (REPM)
Research & Strategy

Shaowei Toh
+65-6495 3778
shaowei.toh@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research