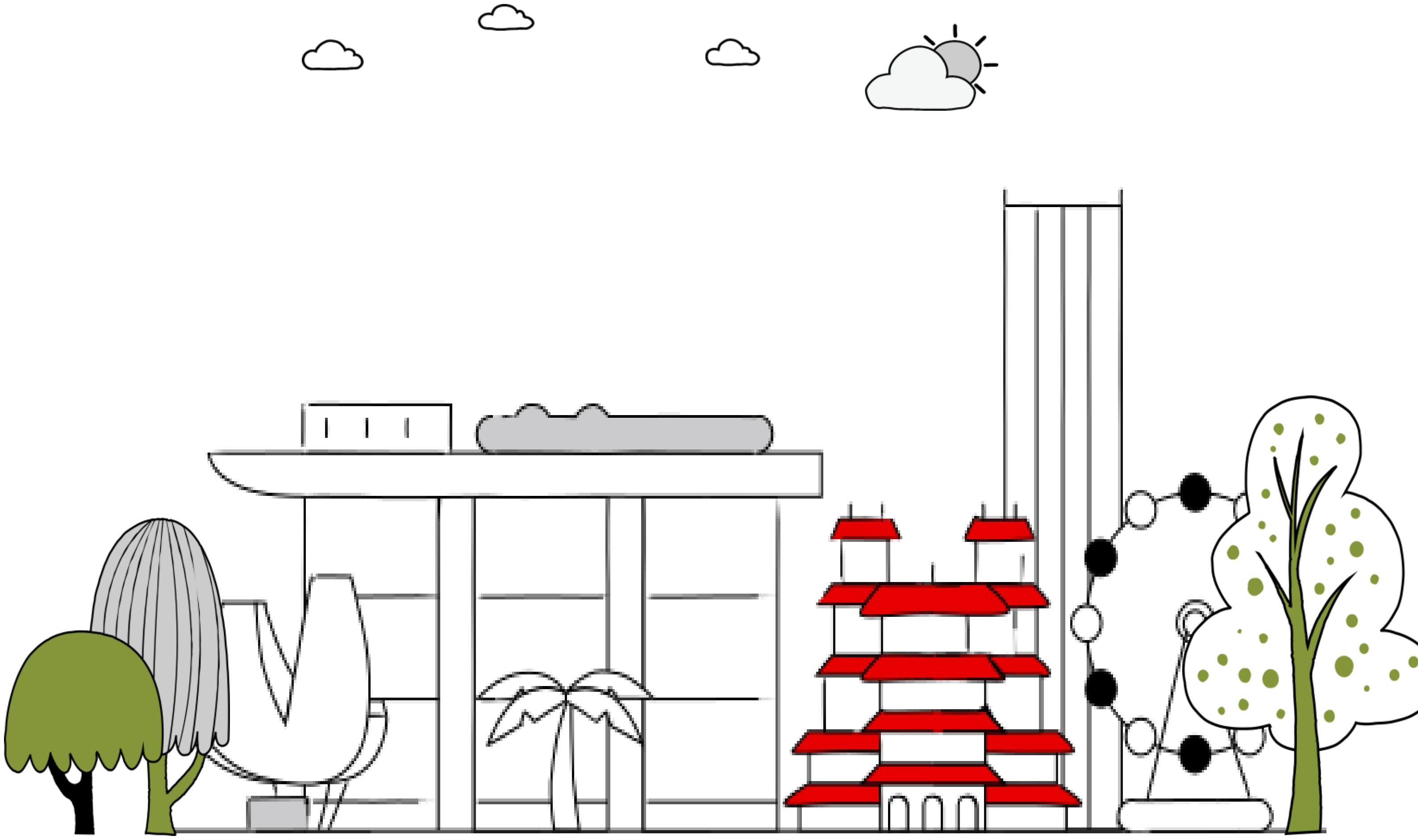
REO

Real Estate Outlook – APAC

Edition May 2023



UBS

APAC real estate

Hitting the pause button

APAC GDP growth is projected to accelerate from 3.1% in 4Q22 to 4.2% 1Q23, according to UBS IB. However, the strong headline number belies a weak showing in a number of countries reported so far. China, Hong Kong and Japan showed strength on the back their late reopening's activity normalization. Beyond that, however, the picture is downbeat. Taiwan's GDP shrank 1.8% QoQ and is in a technical recession after two consecutive quarters of decline. Singapore contracted 0.7% QoQ while South Korea and Malaysia failed to recoup their previous quarter's losses.

Asian exports grew 3.3% QoQ (seasonally-adjusted) in 1Q23 after a high-single digit decline in 4Q22. However, the rebound was almost entirely driven by Chinese exports while most other countries continued to falter. We expect external demand to stay weak in the near-term driven by the ongoing preference for services over goods, semiconductor downcycle and softening global growth.

The slowdown outside China is clear. The sustainability of China's rebound is not. 1Q23 recovery was strong from the late reopening, but momentum seems to have fizzled out in April with softer retail sales, exports and PMI. The property sector is also not out of the woods. Nonetheless, with services output still accelerating, the country is tipped to grow 5.5% in 2023 from a low base, based on forecasts from Oxford Economics.

APAC is in disinflation, after the peak in 4Q22, with CPI YoY falling 0.4ppt QoQ to 4.8% in 1Q23 driven by softening energy and food prices. Core inflation (excluding food and energy) also showed signs of easing in most countries except Japan. Pricing momentum is the weakest in China with headline inflation slowing further to 0.1% YoY in April 2023 amidst slow recovery.

Given the easing price pressure and softening global growth, more APAC central banks have hit the pause button on rate hikes in recent months. South Korea, Singapore, India, Philippines and Indonesia are cases in point. Vietnam went a step further and cut its discount rate by 100bps and refinancing rate by 50bps. On the hawkish side, Australia and New Zealand continued their tightening given the stubbornly high inflation and tight labor market. More could still come but most market watchers believe that the end is near. Oxford Economics forecasts rate cuts to begin only in early-2024. UBS IB is more cautious on the macro slowdown and believes the monetary easing could arrive sooner in 3Q23 starting with South Korea.

"1Q23 economic outcome was mixed and points to a continued weakness. Disinflation endures with more central banks hitting the pause button. Transactional market was lifeless in 1Q23 but shows some signs of bottoming. Opportunities are starting to emerge as sellers lower their expectations."

Wai-Fai Kok
Head of Real Estate
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Grinding to a halt

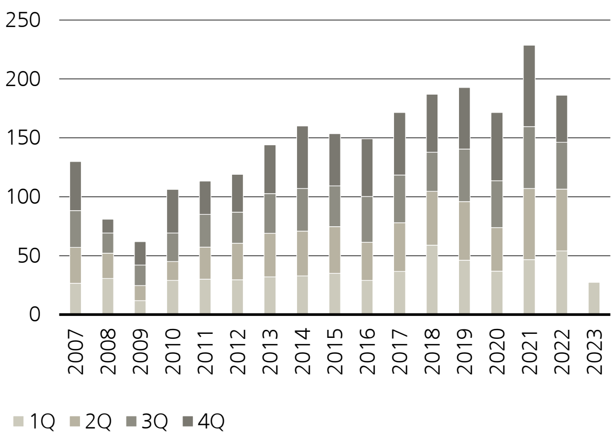
APAC leasing activity softened further in 1Q23 on the back of mounting macro uncertainties. According to CBRE, office net absorption fell 5% YoY, matching 2020's pandemic era levels. Logistics space take-up was down in most countries (except China), but rental growth remained robust. Retail performed better as leasing sentiment improved amidst tourism recovery and rents inched up slightly. The resilient household consumption so far has also supported retail sales. We expect overall leasing sentiment to stay lackluster through 2023 as the economy enters a period of slower growth.

1Q23 was a quarter to forget for transaction activity. It was the slowest start to a given year since the Global Financial Crisis. Pricing adjustments remained sluggish despite sharply higher funding costs and that resulted in negotiation deadlock. Despite accommodative monetary policy, Japan also saw a pullback as investors were spooked (initially) by the surprised tweak to yield curve control in December 2022. In China, the reopening boosted consumption but failed to revive investor sentiment.

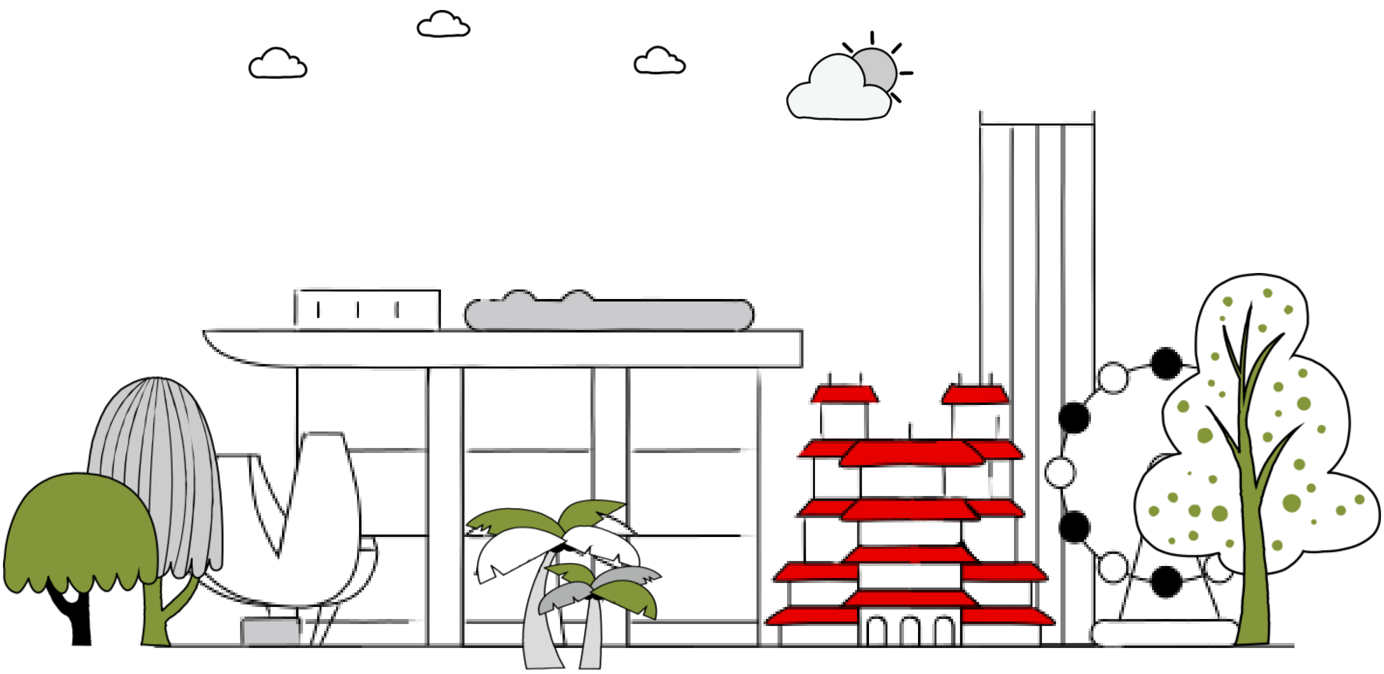
According to MSCI, APAC real estate transactions in 1Q23 plunged 50% YoY to USD 27 billion, undershooting the pandemic low in 2020 and was the weakest first quarter since 2009. Australia (-72%) and South Korea (-78%) tumbled the most given their rich valuations. Japan (-40%) retreated but its solid deal pipeline could drive a rebound in the coming quarters. Singapore (+40%) and Hong Kong (+15%) were the only markets to record positive growth but for different reasons. The former was boosted by Mercatus's large transactions (retail malls) at robust pricing while the latter was led by distressed deals such as Goldin Financial Center.

Cap rate evidence was scarce given the thin transaction volume during the quarter. Nevertheless, real estate brokers' data suggest cap rates have continued to move out. CBRE's indicative prime office and industrial yield in Australia expanded 10-25bps and 15-50bps, while South Korea saw 15bps and 20bps increases. Other countries were largely flat. We expect further expansions in the coming quarters.

Figure 1: Asia Pacific transaction volume (USD billion)



Source: MSCI, May 2023.



Emerging opportunities

The bearish outlook of the US office sector intensified early this year due to regional bank credit concerns and a number of high-profile debt defaults by landlords. This negative sentiment seems to have seeped through to APAC and resulted in more cautious underwritings. Office transactions in the first quarter fell more than half YoY to the lowest since 2010. Listed office REITs have also underperformed. However, we think the fundamentals in this region are much more robust. Leasing demand has weakened in recent quarters but caused more by cyclical drivers than a structural one. Most core markets (except Japan) still delivered positive rental growth in the first quarter, with Seoul the strongest at +3.8% QoQ.

Slow re-pricing has been the key investment hurdle, but opportunities are emerging. Deal activity seems to be picking up again after the first quarter's dry spell. There are signs that potential sellers are starting to lower their expectations. In Australia, for example, several A-grade office assets are in advanced sales negotiations at 15-20% discount. South Korea also witnessed a 10-15% softening, according to JLL. We think such magnitude of adjustments is fair, as opposed to attractive, and reflects the higher interest rate backdrop.

Distressed deals have so far remained limited in most APAC markets but rising in China and Hong Kong. According to MSCI, distressed sales in the two countries amounted to more than USD 2.5 billion in 1Q23, representing about 10% of total volume. This was sharply higher than an average share of 2-4% in the last 4-5 years.

With repricing accelerating, we think the regional office market will soon gain clarity on pricing adjustments required in the coming months. This may also imply that a trough in transactional activity is near. We think the same applies to logistics assets due to their quicker cap rate expansion thus far. That said, this needs not to mean a discounted pricing as rental growth drives yields higher over time.

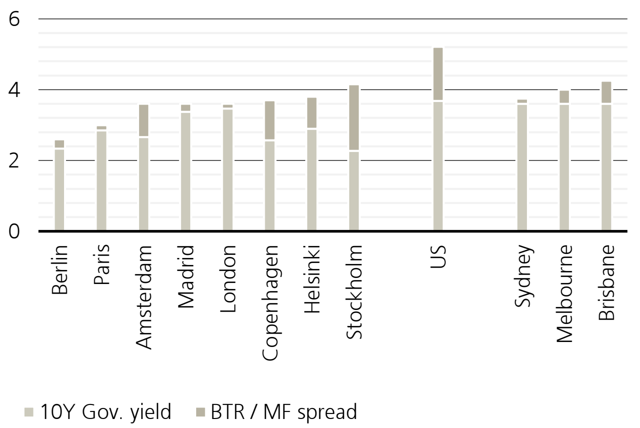
Australia – policy support for build-to-rent (BTR)
The Australian government announced the long-awaited tax cut for foreign institutional investors in the residential BTR sector. In addition to the halving of MIT withholding tax (from 30% to 15% after 1 July 2024), the depreciation rate has also been increased from 2.5% to 4%, which should further improve the tax profile. This indicates the government's support for the nascent sector as a remedy for the country's undersupply situation. As a trade-off, some restrictions were also put in place including a 10-year ownership period and a lease term of at least 3 years.

Overall, we think the new measures are positive and would aid the formation of another residential play (in addition to Japan) in this region over the long term. Nonetheless, making a strong investment case in the near term may not be as straightforward. Pricing and development risks are among the key concerns on the minds of investors in the current macro environment. A funding structure that lowers construction risks may be preferred.

There has hitherto been little price discovery in this sector given a scarcity of deal flow. As such, the valuation for BTR assets is not well established. Ascribing cap rates in this period of sharply higher interest rates would understandably be a difficult exercise. Based on public information, Savills indicated BTR cap rates at 3.75% in Sydney, 4% in Melbourne and 4.25% in Brisbane as of 2Q22. This is broadly consistent with the developer / operator Mirvac's disclosure of around 4-4.1% for its two completed assets in Sydney and Melbourne. Similar to other asset classes, cap rate expansion has so far been limited unlike the US and Europe which have already experienced an average 75bps expansion since 2Q22.

Based on 1Q23 figures, Australia BTR's 40bps spread over 10-year bond yields is lower than Europe's 80bps and US's 150bps, but higher than the UK's 10bps. They are materially below the 10-year average of 280bps, 290bps and 210bps, respectively. Further cap rate expansions looks likely. Applying a stabilized 10-year bond yield of 3% (Oxford Economic's forecast), the yield spreads above imply a 5.1-5.9% potential cap rate for Australia BTR. That said, we think a comparison to UK is more appropriate given their similar characteristics. Comparison to other European markets may also be complicated by rental cap regulations. Coupled with Australia's stronger demographics and rental growth profile, we think a stabilized cap rate at or below the low-end of the range may be fair.

Figure 2: Global multifamily yield spreads (%)



Source: CBRE; Green Street; Savills; Oxford Economics, May 2023.

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