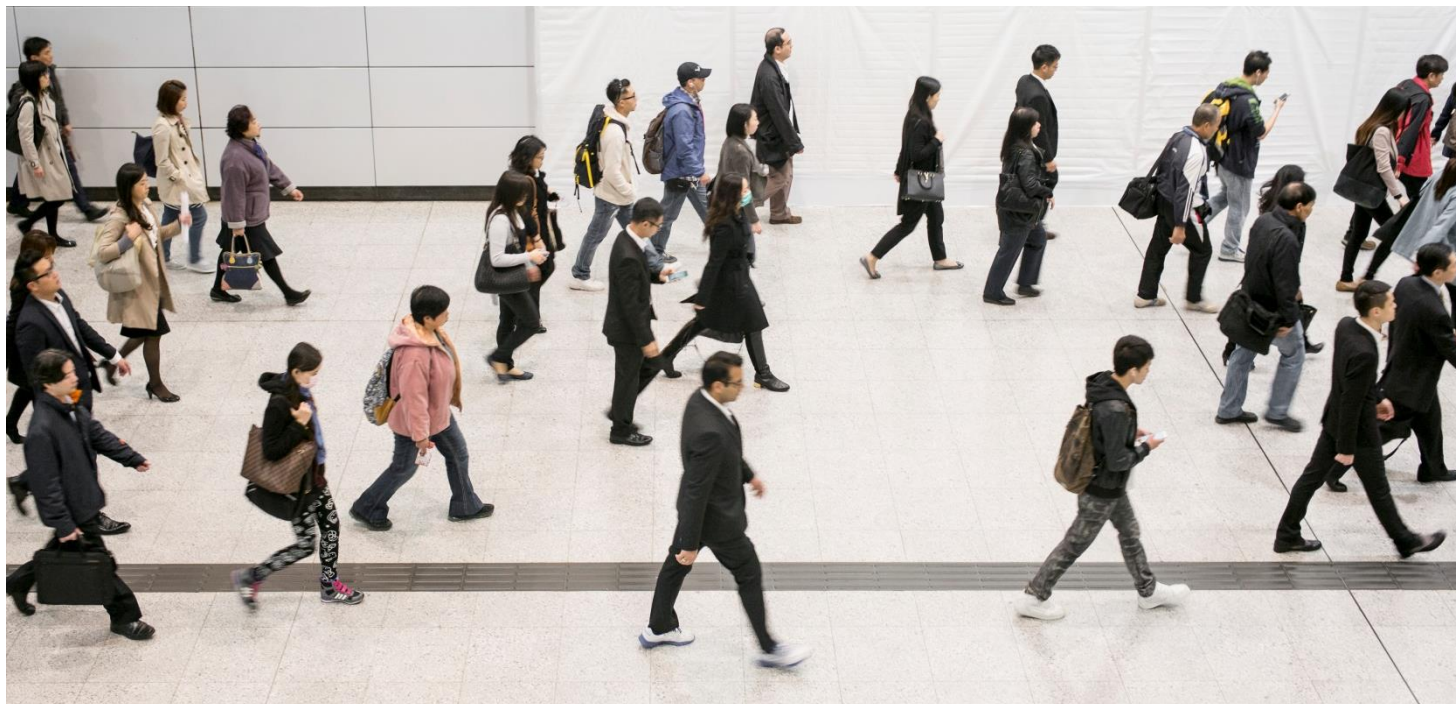


Real Estate Outlook

Asia Pacific – Edition 2020



Stealing a march in the 2020s

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Mixed fortunes offer up diverse opportunity sets in the next five years.



The recently concluded trade deal led to upward revisions in our expectations for Asia Pacific in 2020, but not before the COVID-19 outbreak rewrote the script once again. As we step into the next decade, it is timely to cast our horizons further and adopt a tactical approach towards real estate investing in a cyclical world. Key themes will still drive the medium-term prospects of real estate in Asia. We encourage investors to monitor signposts and risks, and focus on actionable strategies over the next five years.

The future of five in five

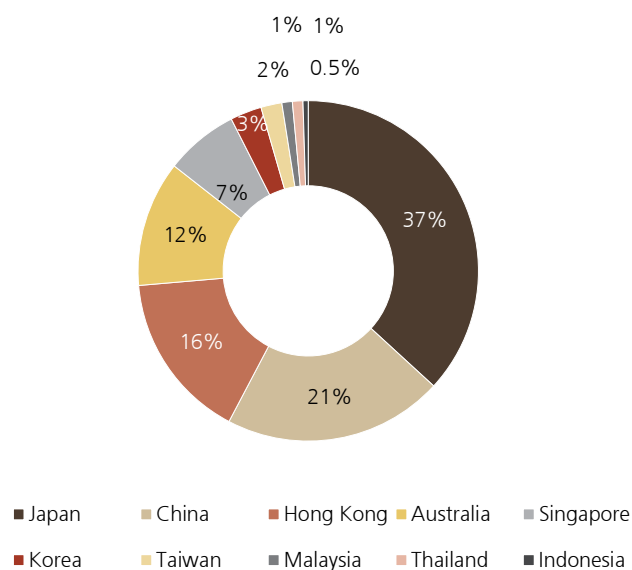
In this edition of our annual outlook, we focus on five developed markets in Asia Pacific, namely, Australia, China, Japan, Hong Kong and Singapore.

Focus on five markets

The Five, as we term these markets, are not entirely representative of the high growth Asian Century story that most investors are now familiar with. And, the Five do not enjoy the same socio-demographic tailwinds that underpin the long-term secular demand for real estate in many emerging Asia markets. Arguably, they will also not embody the high returns profile that is common in many other real estate markets.

So, why concern ourselves with these specific real estate markets? The Five collectively makes up more than 90% of the investable real estate universe in Asia Pacific. And the truth is, investors enjoy much deeper liquidity and ease of transacting in these five Asia economies than they do in many other emerging markets. Also, the reality is, structural fundamentals in the Five are consistently solid and key real estate drivers have been entrenched, tested and proven, over the last few decades. They offer up opportunity sets that are largely heterogenous across market cycles, and that augments the appeal of a mid-to-long term allocation towards real estate strategies in these five markets.

Figure 1: Real estate market size
(2018, USD terms, %)



Source: MSCI (data available as at June 2019)

2010s: The "lost" decade?

Technically, and probably best left for another debate, 2021 marks the start of the new decade. However, this year is the year in which the world marches into the 2020s, and the significance of that cannot be ignored. The 2010s presided over an initial period of growth that rode on the momentum of the post-GFC resurgence, but that tapered off towards the end of the decade, largely hampered by geopolitical and trade tensions.

Notably, average global growth in the last 10 years was similar to that of the previous decade. Most of us probably do not realize that, as our recent memories of the 2008 GFC lead us to conclude that the 2010s experienced a relatively stronger run. Or at least, we certainly felt that way. The real GDP growth rate in Asia – including emerging economies – aggregated at around 5.3% in the last decade, not significantly higher than the 5.2% in the preceding 10 years.

There are various narratives around the point that the 2010s very much resembled a "lost decade" characterized by flat growth, supported by historically low interest rates, as central banks seemingly lost the plot in their monetary responses. In the real estate space, especially in Asia, performance was hardly dismal by any standards. The last decade saw China break out as a mature real estate market, with strong institutional interest supporting steady investment volumes. In markets such as Japan and Australia, wide yield spreads were a semi-permanent feature for most part of the decade.

APAC property appeared relatively attractive and many participants were able to benefit from the capital cycle. Low growth was not precluded in Asia, but consumer and corporate demand were supportive of occupier performance in key Asia real estate markets. As bond yields trended lower toward the late part of the decade, the relative appeal of real estate as an asset class became more obvious to investors.

What will the new decade bring?

Important to cast our horizons further

In previous editions of this report, we emphasized a one-year horizon in our discussion on the performance of key real estate markets and sectors in Asia Pacific. That approach was – and still is – relevant, particularly as exogenous events continue to unfold and stoke near-term uncertainties around the underlying dynamics for real estate. Real estate cycles run in parallel with global cycles, sometimes with a lag, but always never fully divergent. As we step into the next decade, it is important to cast our horizons further and look towards a more practical approach for real estate investing in a neo-cyclical world.

Within allowable fiduciary and governance guidelines, institutional investors should gradually spread out their investment horizon. Because economic and political shifts often unfold across market phases and not necessarily within one cycle, a longer-term perspective will allow for a sharper focus on trends that may disrupt or change the fundamental demand for real estate in Asia.

Looking ahead into the next five years

It would be fairly convenient to paint a 10-year picture, laying out megatrends and putting together a grandiose and futuristic analysis on Asia real estate markets. However we believe that approach will be less than responsible and fair to our readers, as we want to marry long-term views with near-term executable ideas and solutions, and not attempt to be way ahead of our time.

With technology enabling the emergence of trends and opportunities at a quicker pace, we shall take a five-year, secular view here instead, and put forward our perspectives on the key development, threats and opportunities that real estate investors should be informed of when investing into the Five markets in Asia Pacific.

We hope this can help guide strategic thinking in the year ahead, and also prepare our investors to navigate the medium-term nuances of an ever-evolving real estate investment landscape.

2019 round-up and 2020 perspectives

2019 – A year of highs and lows

In the first half of 2019, several economies were on track to record their respective longest expansion phases in recent history. The United States officially crossed that milestone in July 2019, surpassing the previous record of 120 months, and that strong run has continued into 2020. In APAC, Japan marked its longest period of consecutive economic growth since 1945, clocking in at 74 months in February 2019. Over in Australia, another record was being set, as it overtook the Netherlands with the longest period of recession-free growth (28 years). Obviously, as we now look back with our current lenses, those records look precarious, but the point really is that 2019 did not start out as poorly as it almost ended.

After two years of strong tailwinds from the global technology cycle, the mood across most of APAC turned decidedly muted in the later part of 2019. The trade conflict between China and the US has clearly taken much of the flak for that, having intensified since May 2019. As global demand and supply chains came to a stagger, central banks across Asia marched in tandem with the US Fed and policy interest rates hit historical floors in many 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. Elsewhere, the Reserve Bank of Australia (RBA) embarked on three reductions in the cash rate over five months, bringing it down to a historic low in 2019. 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. The Monetary Authority of Singapore (MAS) adopted a more accommodative stance in October 2019, easing monetary policy (via the exchange rate) for the first time in three years.

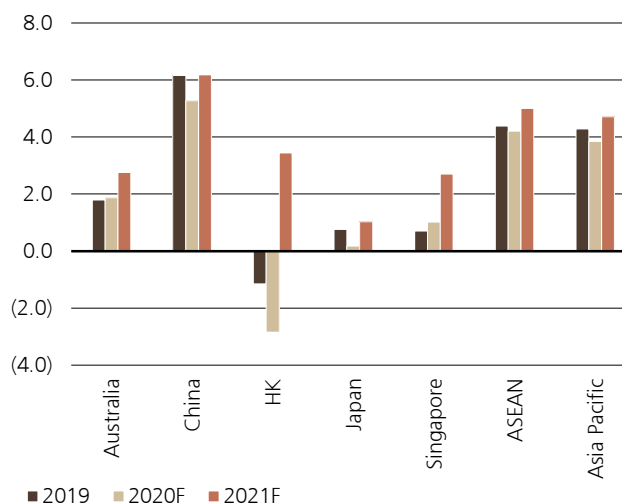
All said, 2019 ended on a better note than it had been playing out for most of the year. For one, unemployment rates stayed low. In Japan, the competitive labor situation was reflected in the unemployment rate of 2.2% in August 2019, the lowest in the last quarter century. The same labor market metric was tight in Singapore, Hong Kong and Australia. 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 almost immediately led to upward revisions of economic expectations for 2020, but not before the COVID-19 virus outbreak rewrote the script once again.

2020 – Will this straw break the camel's back?

At time of writing, the fallout from the COVID-19 virus outbreak remains the biggest dark cloud over the APAC economy in 2020. We felt the jitters for the most part of 2019, arising from trade and geopolitical tensions, and eventually "all's well that ends well". Accommodative monetary policies and targeted fiscal responses were key shows of resilience by many APAC governments, and that helped to stave off a major economic downturn last year.

Figure 2: GDP and forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

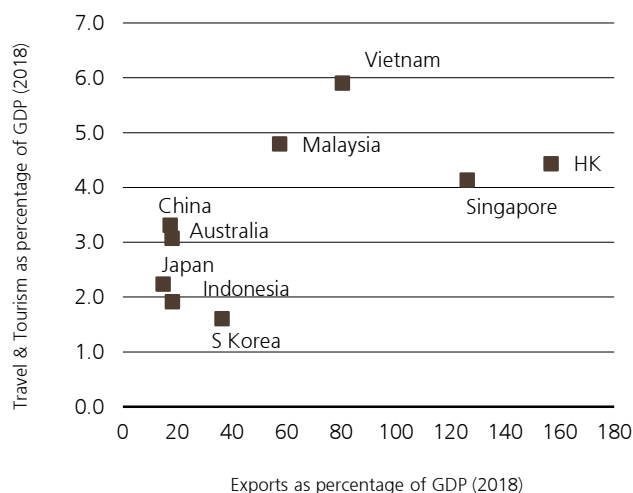
Yes, we have been there before in 2003 during the SARS crisis, and undoubtedly APAC has emerged much stronger and better prepared. There are comparisons around how long this epidemic might potentially last, taking reference from the 2003 episode. However that is best left to epidemiologists to inform, and medical scientists around the world are already scrambling to develop a vaccine for COVID-19.

Notably, the vaccine development process is an arduous one, and it would take from a year to even three years for any vaccine to be clinically tested, before it can be approved for use in humans. Case in point, after more than 15 years, we still do not have an approved vaccine for the SARS virus. Community prevention efforts were much more useful in stemming the contagion back then. The latter point is important, as that essentially means it will take a while for the outbreak to ease off, before life and markets resume normalcy.

While we cannot, at this juncture, quantify the precise economic impact of the COVID-19 on Asia, our base case scenario assumes that the epidemic will be brought under control before 2H20, and that a economic rebound will be experienced in the immediate aftermath. The restocking of inventory and pent-up demand will support private investments and spending, while policy support should cushion further deterioration in sentiments. Also, supply chains and the flow of people and services will recover, albeit gradually.

As at 24 February 2020, Oxford Economics expects that 2020 global GDP will come in at 2.3%, down from 2.6% in 2019. Asia Pacific as a bloc will take a hit in 2020, with GDP growth falling from 4.3% in 2019 to approximately 3.8%, before staging a comeback in 2021. Obviously the downside risk to our base case is very real, and highly dependent on the magnitude and longevity of this viral outbreak, which remain rather indeterminable as yet. For now, APAC economies with higher export orientation and greater reliance on tourism will feel the impact immediately.

Figure 3: COVID-19: Trade and tourism dependence
(% of GDP, 2018)



Source: World Bank, CEIC, UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

COVID-19: What we will learn after this episode is over

Real estate investors in APAC will be able to glean a few insights from this global health epidemic, and we believe developments in the past month have accelerated and corroborated some emerging themes in the real estate space.

Selective on China industrial real estate:

The re-routing of supply chains out of China will likely pick up pace, and even become a priority for many industrialists. The world learned the hard way in 2019, as the US-China trade flare up resulted in collateral damage for manufacturers with substantial production linkages within China. With severe disruptions in the availability of intermediate production components and not helped by the long (uncertain) period of factory closures, many producers will see this episode as the validation that is needed to diversify their exposure to China.

Are we implying that investors steer clear of the industrial property sector in China? That is not totally the case, but this virus pandemic does highlight the certainty that low-end manufacturing will start to exit China. And in place, real estate investors should be looking at logistics that cater to the e-commerce story, and high-end manufacturing and production facilities that continue to be a long term ambition of China's "Made in China 2025" plan.

Hold your horses on SEA logistics:

The second learning point is related to the previous one. The trade war in 2019 had investors really excited about the prospects of the industrial real estate markets in Southeast Asia (SEA), particularly Vietnam, Indonesia and Malaysia. We do not think that this has changed with the COVID-19 issue, but we do want to caveat that manufacturing in SEA is highly dependent on China.

The complexity of China's embeddedness in the regional supply chains should not be underestimated. This virus outbreak has already exposed the weakness of many emerging SEA markets struggling with the potential value chain disruptions. Even if the industrial sector in SEA benefits significantly from spillover effects, intermediate production goods in many instances still rely heavily on China's exports. In the near term, there will not be a total hollowing out from China, as the displacement will take years to be effective for many players looking at SEA's industrial sector.

Office tenants review real estate requirements:

The notion of mobility and flexible working is being truly tested during this COVID-19 crisis. As countries seek to limit human-to-human contagion, many companies have activated business contingency plans and home-based working is becoming a daily routine for many workers. In other instances, employees are dispatched to alternative work locations where they can perform the same functions with the aid of technology.

Before this epidemic, working from home or mobile working was arguably more a concept that was "good to have" but never really implemented in a big way, at least in most of APAC. When this COVID-19 outbreak is behind us, we believe many office tenants will review their fixed real estate space requirements, especially if this involuntary experiment with mobile working has resulted in comparable levels of efficiency. It does not mean that companies will cut down on their office footprint drastically, but it is likely that there might be a stronger inclination towards shared workspaces, which frees up the long-term lease commitments of many office tenants.

Corporate demand for co-working or flexible working spaces should get a boost, as it becomes increasingly clear that technology can enable the optimization of office occupancy costs without sacrificing productivity. This is not all good news for office landlords but it does suggest that adopting active leasing strategies to capitalize on the workspace of the future may bear fruit for pre-emptive office space owners.

Greater aversion towards hotel and retail sectors:

There has already been a general reluctance and aversion towards investing into sectors and markets that rely heavily on tourism and human flow. The GFC and SARS outbreak exposed many hotel and retail investments to huge fluctuations in capital values and income, as the tourist tap seemingly turned off overnight. We can list Japan hospitality as a prime example, where even the recent allure of the tourism story in Japan could not motivate most conservative investors.

Indeed, some sectors are susceptible to even the mildest of disruption in the movement of people across borders, and that could be caused by geopolitical factors, not necessarily a virus outbreak. We expect that investment return requirements in the hotel and selective prime retail segments may be adjusted upwards. However, from a bottoms-up perspective, we remain positive on assets that embody strong locational attributes and are more resilient.

Office: Divergent cycles

Performance in the APAC office sector will be mixed in 2020 as office cycles remain divergent. While economic fundamentals 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.

Although office vacancy rates remain at historical lows for the gateway cities of Sydney and Melbourne, rental growth is starting to stabilize after more than four years of growth. Following an unspectacular 2019, rent growth prospects in Beijing and Shanghai are among the duller in Asia – the influx of new office supply in decentralized locations underpins our weak rent outlook.

In Hong Kong, the office leasing market felt the chills from the double whammy of the US-China trade dispute and the ongoing social unrest, with the COVID-19 outbreak adding a third layer of complication. 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.

Over in Singapore, main leasing activities have been focused on consolidating of office space and a general flight to quality. Purely from the supply side of the equation, the next major wave of completions will occur post-2021, which is supportive of near-term rents and occupancy, although we remain skeptical as to how favorable demand factors are.

The Tokyo office market has pleasantly surprised in spite of the higher levels of completions in the last two years. Recent changes in labor laws have indirectly increased the requirements in employee headcount and office space by Japanese companies, and that will continue into 2020.

Industrial: Still an e-commerce story

Despite the worsening manufacturing and export momentum in late 2019, industrial real estate's performance continues to hold up, supported by demand from e-commerce and third party logistics (3PL) companies and a lack of available space in some markets. In many APAC cities, demand is also coming from food manufacturers amid a rising trend of food delivery services, and the need to centralize and automate due to high labor costs and retail rents.

Competing uses of land have reduced the amount of space available for the industrial sector, thereby providing an impetus for rent growth in places (such as Australia and China) where stock has tightened rapidly.

We did not see entire supply chains migrate to Southeast Asia in 2019, 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. That will continue to be the theme in 2020, particularly as greater demand for last mile logistics (owing to the COVID-19 outbreak) negates the slowdown in trade-related activities.

Retail: Focus on resilient retail attributes

Retail sales in most of Asia have mirrored languid consumer sentiments, not just in 2019, but arguably since late 2018. Wage growth, or rather the lack thereof, 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 many APAC markets, geopolitical tensions have affected absolute tourist arrivals numbers; and the virus outbreak in 2020 almost looks to be the final nail in the coffin. Or is it?

The truth is that urban layouts in most Asian cities are supportive of retail, and to some extent we do not expect a complete meltdown. The danger is in writing off retail altogether when well-located malls with stores and services that cater to consumers' needs are still a core part of the physical landscape. The hard part is figuring out what works in an ever-evolving retail scene.

Even with e-commerce, it is not a one-way migration of consumers from offline to online – observations in Australia suggest that having a web presence also increases physical footfalls and in-store purchasing activity, a trend which is now deemed as Research Online, Purchase Offline (ROPO). E-tailing giants in China are also showing huge appetite for offline expansion as they create a "boundary-less" retail environment. In 2020, we encourage investors to cut through the noise and focus on resilient retail asset attributes. There is also a window of opportunity to acquire retail assets that have seen some capital value adjustments but offer significant scope to buy and fix.

Capital markets: Marginal cap rate compression in 2020

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property dropped by approximately 11% YoY in 2019. 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.

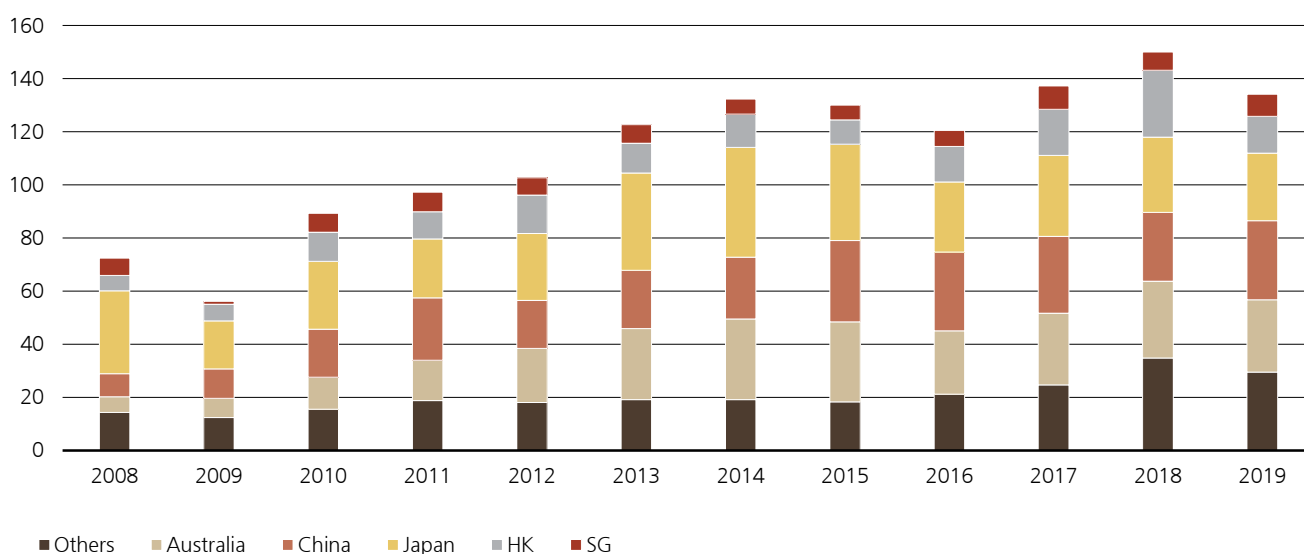
On a market-level, Hong Kong saw the biggest absolute and YoY decline in investment volumes in 2019. The last quarter of 2019 also marked the lowest quarterly investment volumes since 2009. A clear juxtaposition of contrasting fortunes can be found in the Singapore investment market.

Anecdotal evidence suggest that investors are willing to take a longer-term view of the Singapore market and tolerate slightly tighter entry cap rates, in exchange for stability and capital preservation. China still makes up the bulk of APAC commercial real estate transaction activity, as foreign institutional and sovereign capital remain positive on the prospects of China's commercial markets.

Should our base case assumption for the COVID-19 epidemic hold, in particular the likelihood of the pandemic easing off by mid-year, we can expect to see a late rebound in transaction volumes in the China commercial real estate market. We are highly cognizant that the long term fundamental conditions in China have not really been altered even with the virus outbreak. Growth is slowing, and geopolitics will continue to weigh on sentiments, but these are not at all new. However, the immense market size, urbanization and development upside in China will still offer up opportunities for the savvy investor.

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. Lastly, 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.

Figure 4: APAC commercial property investment volumes
(in USD billions, excluding land sales, hotels, apartments, senior housing)



Source: Real Capital Analytics (as at 13 February 2020). UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

Key themes to watch

Scoping the landscape in the next five years

Market trends have evolved rapidly in the past decade. Some buzzwords are becoming the norm in recent years - Globalization. Technology. Social awareness. Demographic shifts. Connectivity. Environmental consciousness. Populism. This list of enablers is non-exhaustive, and has influenced how real estate is being perceived and utilized, which will continue to alter the landscape we operate in.

Will people migrate to the planet Mars in the next few years, rendering all real estate obsolete on Earth? Now, that is a question which panders to the futurist's instincts and is probably too far off from our current reality to affect how investors should be positioning their property portfolios. Instead, in this report we are concerned with emerging near-term themes that require investors to sit up, start thinking and begin acting on, so as to optimize their returns or reduce their risk exposures.

In our minds, we strongly believe the following themes will be deeply entrenched into real estate strategies within the next five years, and while some of these are not new, the impact on the real estate landscape will be felt more strongly than in the past decade.

Space-as-a-service to become mainstream

Corporates and end users are increasingly rejecting the notion that real estate is a fixed cost, and are embracing the concept of space-as-a-service, enabled by shifts in technology and mindsets. This has manifested itself in self-storage, co-working and short-term accommodation, amongst others. From the landlord and investor point of view, the commercial viability of flexible solutions is debatable, at least for now. However, the real estate industry has always been quick to respond to the changing needs of end-users and this cycle is no different.

Increasingly, in many APAC markets, flexible working operators have dominated the absorption of office space. We tend to think that the end users are start-ups or project firms, but the COVID-19 outbreak has really opened up the possibility of corporates becoming a bigger part of co-working. The ability to tap on space on demand, as if it is a service, can greatly reduce the need for corporates to hold long term leases for spaces such as meeting rooms or innovation labs, to name a few.

Looking ahead, we can also expect the retail and logistics sectors to accelerate the adoption of plug-and-play formats. The retail segment was the first to be affected by technology and changing consumer habits, but landlords are now offering excess space on short leases. There are already aggregators that serve to link up landlords and transitory tenants, and we can expect this trend to pick up as retailers adapt to smaller footprints. In the logistics sector, pop-up supply chains are

evolving. Especially for smaller e-commerce players, temporary and on-demand logistics provide a solution for expanding fulfilment capabilities during peak periods. The logistics sector will see a slight shift from build-to-suit towards a build-to-serve model.

Housing the masses is a big deal

Multi-family investment is on the rise, going from 13% of global transaction volumes in 2009 to 23% in 2018. Interest is supported by structural demographic changes such as growing urban populations and delayed family formation. These facilitate the growth of the rental market. Rising home prices and declining affordability further support renting over buying. While the investment case is strong, home price growth has outpaced income gains, putting homeownership increasingly out of reach. This could foment social tension given that housing is considered a basic necessity. As it is, rising rents and the lack of affordable housing are increasingly part of the populist agendas in many countries, exacerbated by slow policy responses on the supply side. And this deserves the attention of investors, as we expect that favorable policies will come on-stream to support the mass housing and multi-family sectors.

In Australia, population growth has really stretched the limits of the housing stock. Net overseas migration in Australia has been at record highs, resulting in an increase of 1.1 million new residents over the past five years. And, while Japan has been under increasing strain from an aging population, inorganic population growth is still very strong in the metropolitan of Tokyo, Osaka and regional cities such as Nagoya. The drivers of demand for multi-family are very pronounced, where migrants flock to key cities for employment, and choose to lease small apartments for the sake of affordability. In the face of growing populism, housing the masses presents a role that the private sector can play in addressing a pressing social need.

Demographic pressures

Projections by the United Nations show that 11.8% of the population in APAC will be older than 65 by 2030, up from the 7.5% as at 2015, and that for the five countries that we focus on will be even higher at 18% by 2030 – or an average addition of 8.3 million people per year between 2015 and 2030. The impact that an older population profile has on an economy has long been hashed out – namely lower productivity levels, increased social spending and reduced tax revenue – but these issues are slowly being addressed. China is turning old as quickly as it is turning rich, while Japan cranks up its labor productivity via significant investments into R&D. Advances in technology enable robots to take on a bigger share of manual labor and policy changes are focusing on retraining and upskilling older workers while gradually encouraging people to stay in the workforce for longer.

An aging population would also unlock the potential for new asset classes – not least senior housing, which itself runs the gamut from luxury retirement villages to the more operationally-intensive nursing care facilities. To be sure, it does not always mean that once someone crosses the age of 65, they would always want to move into another kind of housing, with studies showing that many decide to age in place. And so another way to play the aging theme would be to invest into property sectors that would benefit from increased silver spending, such as healthcare services and even select hospitality plays.

Niche segments joining the mainstream

The amount of capital looking to invest in real estate has been rising ever since the GFC ushered in a period of low interest rates and according to Preqin, global closed-end private real estate fundraising hit a record high of USD 151 billion in 2019, while the USD 319 billion of dry powder as at end 2019 still hovers around all-time highs. Inadvertently, we have also seen the rise of money flowing into alternative real estate segments, with traditionally niche sectors such as data centers increasingly becoming the norm. To be sure, this increase in investments can also be justified by the unprecedented structural changes in technology and demographics which have altered the way real estate is being utilized, such as the evolution of e-commerce and a greater need for flexible logistics spaces to be closer to population centers. But this does beg the question of whether there should be a redefinition of what constitutes the investable real estate universe.

Can anything that takes up physical space be monetized and used to generate returns? Recent years have seen the rise of education as an investment theme – whether that means investing into a fund with a portfolio of kindergartens or purpose-built student accommodation – but other more exotic asset classes which have crossed hands include carpark spaces in Hong Kong and columbariums in Seoul.

Real estate private equity will continue to seek out these property types and operating platforms, but as a word of caution, we think it is important to highlight that niche property types face two major challenges: (i) a small investment universe; and (ii) exposure to regulation. Investors most suited for niche sectors should be ready to commit to longer-term horizons and remain cognizant of the need for specialized knowledge and advanced due diligence given the heightened regulatory, operating and liquidity risks related to these property types.

ESG awareness in the built environment

The last two years have seen awareness of Environmental, Social and Governance (ESG) issues propel to the top of the agenda of many investment managers amidst growing pressure from investors, regulators and the general public, and an increasing realization of the damaging effects of untethered profit maximization. Major environmental disasters in 2019 such as the bushfires in Australia and Typhoon Hagibis in Japan also saw the impact of climate change begin to hit home and raised the urgency around the need to address this. And with the built environment estimated to account for 40% of annual global greenhouse gas emissions, scrutiny over what the real estate sector is doing will grow.

Under the C40 Cities network, a group that connects 96 cities globally to take bold climate action, in 2018, 19 cities around the world including Sydney and Tokyo have pledged to cut carbon emissions by ensuring that new buildings in these cities operate at net-zero carbon by 2030 (and eventually meet the target of making all buildings net-zero carbon by 2050). In the coming years, these cities will likely roll out incentives and programs to enable the transformation and minimally, real estate players in these cities are expected to comply with any mandatory requirements.

But as the whole sector starts moving in this direction, companies which are early adopters and actively incorporate environmentally-friendly measures such as minimizing energy consumption through design features, attaining high energy efficiency standards, and generating energy on-site might eventually be rewarded with a big-enough "green premium" to offset any upfront costs needed to get there. Conversely, those who fail to keep up with these trends might gradually find themselves penalized either through higher operating costs or with a "brown discount" on their buildings.

In the longer term, there are important reasons for real estate players to take climate action given that 11 of 15 cities most at risk to rising sea levels are in Asia, according to a report by risk consultancy Verisk Maplecroft. A lack of action would eventually see values being eroded and buildings rendered obsolete, and although this is to play out over the longer term, the steps being taken now would determine the likelihood of that scenario becoming a reality.

Australia



Signposts

- Commitment to fiscal discipline
- Rollout of ongoing tax reforms
- Infrastructure projects completion progress



Threats

- Resurgence in home prices is unsustainable
- Record high household debt
- Labor market softness may persist



Opportunities

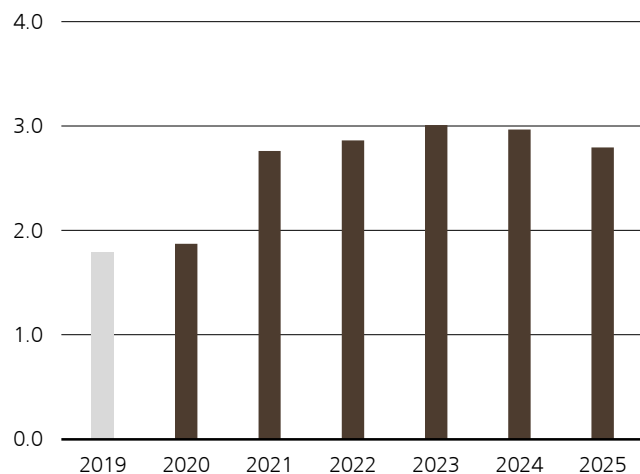
- Prime logistics returns to stay strong
- Built-to-rent sector nascent but high potential
- Regional office markets catching up

The run continues, albeit on an uneven terrain

Having been on an almost three decade growth streak is an enviable feat for any advanced economy, and Australia has so far managed that hat-trick on the back of a confluence of factors, from rich natural resources and favorable commodity prices, a diverse services sector, a skills-based immigration policy which has led to growth of the population and labor force, amongst other factors.

Figure 5: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
 Note: Data for the period 2020-2025 are forecasts.

Despite this, there are signs that the economy is in a soft patch, with most of the weakness stemming from the domestic side, with businesses holding back on investments and households similarly starting to curtail spending on the back on an increasingly bearish external outlook. The bright spots in 2019 were public sector consumption and net exports, and while these are likely to continue contributing to growth in the near-term, they cannot be relied on forever. Net exports, in particular, will soon be put to the test amid the COVID-19 outbreak, given the heavy reliance on demand from China.

Signposts we are watching out for

The Reserve Bank of Australia (RBA) has been on an easing cycle and most recently trimmed interest rates to a historical low of 0.25%, in a pre-emptive move catalyzed by the COVID-19 outbreak. Fiscal support has similarly been instrumental to growth but going forward, the question is how much of a part that would continue to play. Prime Minister Scott Morrison has made returning a budget surplus in the near and medium term a key campaign pledge in his re-election bid in 2019, promising to undo what he calls the fiscal mismanagement of the previous government while still delivering on a stronger economy and job creation. His commitment to fiscal discipline is now coming under pressure given the double whammy of the devastating bushfires and the COVID-19 virus. Will the current administration abandon this commitment?

In November 2019, it was announced that AUD 3.8 billion worth in spending on rail and road projects will also be brought forward to boost jobs and wages. The calls for stimulus spending will likely continue to grow stronger as the effects of reduced demand from China and disruption in global supply chains start to be felt, and the authorities' position on public spending will be an important factor in determining the near-term outlook for the economy.

An adjacent policy issue is that of the Morrison government's proposed tax reforms, which centers on a AUD 158 billion income tax relief plan that aims to reduce the tax burden of more than 10 million workers. In July 2019, the Senate voted to pass the changes, leading to the start of a multi-year, phased plan that will simplify and flatten the tax system by 2024/25. Rebates for low- and middle-income earners have already kicked in and over the next five years, the government will gradually lower the middle tax rate such that the majority of taxpayers will face a marginal tax rate of 30% or less by FY2024/25.

With a sluggish economy and household consumption stalling, the extra cash will likely provide support to consumers over the coming years, despite criticism that the changes will result in low-income earners shouldering a larger share of the total income tax burden. Plans are also in the pipeline for small businesses, where FY2021/22 will see the tax rate for small and medium-sized companies fall from 27.5% to 25%, which will benefit about 970,000 companies employing about 5 million workers.

The next five years will also see several major multi-year infrastructure projects across different states in Australia gradually reach completion. Many of these are rail projects, both inter-state and inter-city, and include the likes of the Sydney Metro, the Melbourne Metro Tunnel and the Melbourne to Brisbane Inland Rail. Most of the major infrastructure plans are in New South Wales and Victoria, the states with the largest economies, but there are also investments to improve the networks in Queensland and Western Australia, which would raise the investment prospects of the regional cities of Brisbane and Perth.

The most obvious benefit of these infrastructure projects will be to improve connectivity. Production capacity will be increased, such as the Cross River Rail in Queensland that is expected to free up a major transport bottleneck. These new developments will also serve as needed infrastructure to cope with growing areas, such as the Western Sydney Infrastructure Plan and the Western Sydney Airport which will benefit the region's expanding population. This is likely to keep the building and construction sector busy in the coming five years, which will continue to support the prospects for occupier demand in the industrial property market. Certain office markets have also seen an uptick in demand from the engineering industry, although the positive spillover benefits are likely less direct.

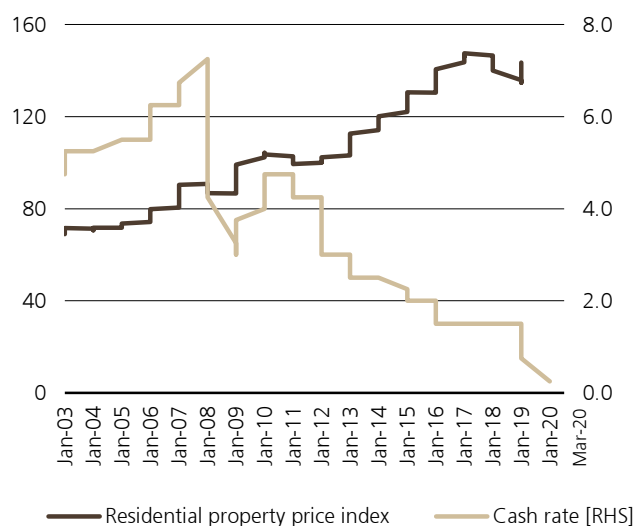
Imminent threats

One of the key risks to watch over the next five years is the resurgence in home prices, raising fears of a property bubble. To be fair, the existence of a bubble is difficult to identify until after it bursts, as former US Federal Reserve chairman Alan Greenspan puts it, given that rising prices could be a reflection of the increase in fundamental demand – as is the case in Australia given the healthy levels of population growth seen there. Nevertheless, the residential property price index (RPPI) has generally only been on an upward trend since the earliest available data in 2003.

Despite continued record low interest rates and strong population growth in major cities, the housing boom slowed from 2017 onwards, mainly on the back of tighter investor lending rules (interest-only loan cap of 30%) introduced by the Australian Prudential Regulation Authority (APRA) in March 2017. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry also stemmed credit growth in the personal housing mortgage sector as banks started to apply greater scrutiny on lending activities.

This led to a 5% fall in the residential property price index over the course of 2018 and while the price correction continued into early 2019, the trend started to reverse in mid-2019 after APRA eased off on its macroprudential measures. This came amid growing weakness in the economy and ran parallel to the start of the RBA's own easing cycle, leading to a resurgence in home prices and raising concerns of a credit-fueled housing price boom (Figure 6).

Figure 6: Australia home price index vs cash rate
(2011-12 = 100, %)



Source: CEIC, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

While the latest RPPI data showed a strong-but-still-manageable 2.4% quarter-on-quarter (QoQ) pick-up in 3Q19, other more granular data indicate that this recent recovery is the strongest on record, propelled by double-digit increases in Sydney and Melbourne over a period of only about half a year. Furthermore, the run-up in home prices have exceeded that of wages over the years, where the RPPI rose about 60% between 2009 and 2019 while the seasonally adjusted wage price index only increased by about half of that at ~32% over the same period. The natural question that follows would then be how these developments affect housing affordability.

What makes a housing bubble particularly worrisome is the fact that household debt levels are around record highs, a risk that is concerning enough on its own. The household debt-to-disposable income (DTI) ratio has been rising over the past few decades and recently hit a high of 188% in 2Q19, making Australian households among the most indebted worldwide.

Unsurprisingly, the increase has been driven largely by property loans and this then makes the risk of a major housing market correction even more significant, with the illiquid nature of real estate placing over-indebted households at risk of default. Negative gearing is a common feature in Australia, and while it reduces the overall tax burden of home owners and investors, a sharp fall in property prices could compound losses for over-leveraged households.

In a somewhat assuring sign, 3Q19 saw the household DTI slip slightly and the recent rebound in home prices has not been accompanied by a sharp rise in credit growth, which seems to suggest that households are paying down their mortgages with the tax refunds they have received from the Morrison government. Nevertheless, the elevated household debt levels still increases the vulnerability of consumers particularly in the event of an economic shock, and also poses risks to financial stability.

We are monitoring for indications of softness in the labor market. To be sure, jobs growth is still healthy with an average net addition of close to 22,000 jobs per month in 2019 – higher than the 10-year average of 16,000 jobs per month – but looking at aggregate numbers alone are not enough to give a nuanced picture of the employment scene. A distinction needs to be made between full-time and part-time jobs, and data in the later months of 2019 seem to suggest a plateauing of the growth of full-time positions.

Part-time jobs taking up the mantle is just one hint of the spare capacity in the labor market; a recent survey by the Australian Bureau of Statistics also shows that around a quarter of the respondents who were employed part-time wished to be working 14 more hours per week. Job mobility is also at its lowest in decades with the average time that an employee stays on in a job rising, which is the opposite of what a tight labor market would exhibit.

Wage growth remains sluggish as a result, but this is an issue common across many countries right now and there are no quick fixes in sight. The impact of a soft labor market will manifest itself in the retail sector which is already struggling with declining shopper traffic and spending, affecting the performance of retail real estate across Australia.

Opportunities in the next five years

Despite the risks facing the domestic sector, Australia's medium term outlook still remains positive on the back of drivers such as population inflows, continued strength in the resources industries and growth of the services sectors.

We have a positive outlook on the prime logistics market. Total returns in the prime Sydney and Melbourne warehouse markets are projected to be among the highest across all real estate sectors in the key developed APAC cities over the next five years, bolstered by a combination of relatively high yields and moderate levels of projected rent and capital value growth. Not only will the expanding population lead to increased demand for goods, the spatial layout of Australian cities also lends itself to a natural inclination towards online shopping, which Property Market Analysis expects to rise from ~10% of total retail sales in 2019 to about 15% by 2024.

On the business side, upgrading activity is also seeing increased demand for high quality warehouse space as occupiers seek efficiency gains. Vacancy rates have been trending downwards over the past few years but supply is now picking up, with a growing proportion of speculative developments. This has so far not posed too much of a concern, with robust demand resulting in even speculative space being filled up in a matter of months. In the medium term, with new supply coming in, there will inevitably be a divergence between better-located, high specs space and those which are not so well-located, but the major infrastructure projects could also eventually improve the connectivity of further away locations.

The challenges of the housing market have also resulted in the emergence of an asset class which we think is ripe for development – and that is the multi-family, or built-to-rent, sector. Years of rising home prices have seen more and more people turn to the rental market for accommodation, but alongside this is the structural trend of increased in-migration, supported by Australia's liberal immigration policies.

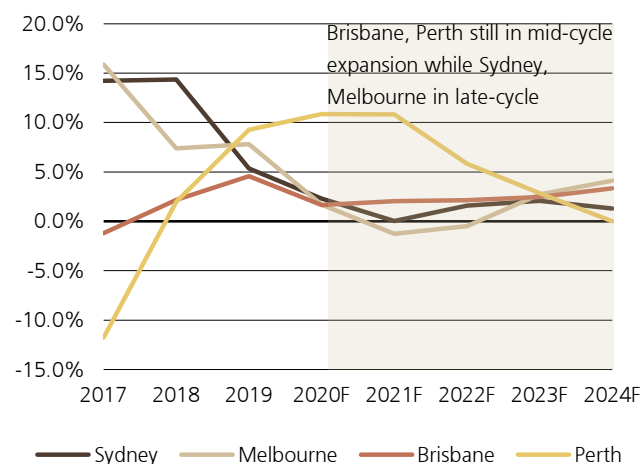
New migrants are likely to turn to the rental market when they first arrive, and the upwardly mobile might even choose to rent in a high-rise apartment in the city center which offers proximity to amenities, a preference that the younger generations might also have, at least temporarily amidst delayed marriage and homeownership. Although regulatory hurdles exist, and the initial economics may not add up, we think that there is immense potential within the nascent Australian multifamily sector, which is likely to benefit early movers.

The office markets of Sydney and Melbourne have been strong outperformers in APAC in recent years. Sydney is typically the first port of call for investors, being the country's commercial center, while Melbourne follows closely behind. That said, having already seen multi-year rental growth, we think that the next few years could see opportunities come up in the regional office markets of Brisbane and Perth instead.

After years of lagging behind Sydney and Melbourne, net effective rental growth in the Brisbane and Perth office markets are now starting to play catch-up, buoyed by improvement in commodity prices and a resurgence in mining investments which lifted their economies.

This has led to a recovery in demand for office space, which is set to continue given strong population inflows, healthy white collar employment growth and the expansion of the services sector in Brisbane, as well as a pipeline of mining investments in Perth. And while the next cycle of office completions is about to kick in in Sydney and Melbourne, the dearth of completions in Brisbane and Perth will likely provide some upward momentum to rents. The next few years will thus see net effective rental growth in Brisbane and Perth overtake Sydney and Melbourne (Figure 7), although some caution is warranted for Perth given its heavy reliance on the resources sector.

Figure 7: Australia office net effective rent growth (% YoY)



Sources: CBRE, UBS Asset Management, Real Estate & Private Markets (REPM), March 202

China



Signposts

- 2020 target of doubling household income
- 14th Five Year Plan (2021-2025)
- 20th Congress of the CCP in 2022



Threats

- Simmering trade tensions
- Slowing residential market has wide impact
- The unwilling Chinese consumer



Opportunities

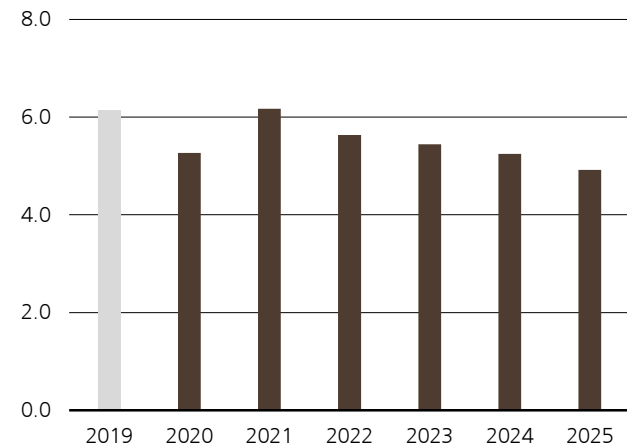
- Made in China 2025 a boon for Industrial
- Cold chain logistics is niche but growing
- South China real estate markets on the rise

Much at stake, but China will not break

Every year in March, we look towards the annual National People's Congress (NPC) in China and attempt to make sense of the signals that could guide our macro views. At the point of this writing, China has postponed the 2020 NPC sessions due to the COVID-19 pandemic. There are reports that more than one-third of the NPC delegates are local officials and it is not the best of times to be distracted from the ongoing fight against the virus. In terms of growth targets for 2019, China put forth a range of 6.0% to 6.5% - And indeed China grew at 6.1% in 2019. Assuming that virus outbreak is contained before mid-year, we expect economic activity to ramp up immediately, and full year growth to come in at 5.0% to 5.5%.

Figure 8: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
 Note: Data for the period 2020-2025 are forecasts.

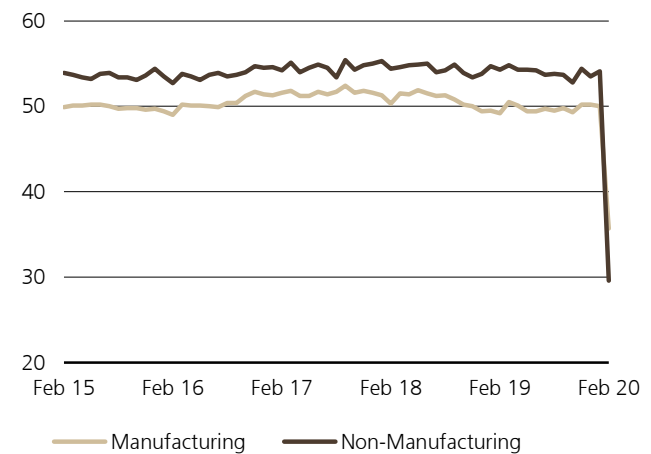
The latest Purchasing Manager Index (PMI) reading in February 2020 saw the Manufacturing PMI plunge to 35.7, a sharp drop from the 50.0 in January 2020, and possibly the lowest on record. Services related sentiments also retreated, as Non-Manufacturing PMI posted the deepest contraction on record, dropping from an expansionary 54.1 in the first month of 2020 to 29.6 as at February 2020. Services now account for almost 60% of China's GDP and this pillar of support is particularly critical to China as trade tensions continue to simmer against the backdrop of the COVID-19 fallout.

But not all is lost. 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. The PBoC revamped China's loan prime rate system in August 2019, seeking to narrow the gap between bank lending rates and money market rates.

The one-year loan prime rate has already been cut three times in 2019. In late February 2020, the PBoC trimmed the one-year and five-year loan prime rates in a further bid to support the economy and corporates. We are not expecting a huge stimulus in the form of helicopter money or a non-targeted liquidity slush, as China would have learned its lessons from the credit-fueled stimulus of 2008, of which it now continues to struggle with the consequential ramifications.

Figure 9: PMI Index

(Reading above 50 denotes expansion)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

China's situation is always being compared to that of Japan's experience since the 1970s, but the difference is as uncanny as the similarities are. Japan dealt with the challenges of rebalancing from investment to consumption in the 1970s, wrestled with a credit and asset bubble in the 1980s, and has grappled with a rapidly aging population since the 1990s. China, meanwhile, has the undistinguished burden of contending with all three issues at the same time. No doubt it is always easy to extrapolate and assume that economic history may provide textbook answers as to how China should and would manage its problems, but more often than not, we neglect to see China's current conundrum in its entirety.

Signposts we are watching out for

In the 13th Five-Year Plan (2016-2020) issued in late 2015, the Chinese government reaffirmed its goal of doubling household disposable income from 2010 levels by the year 2020. This was a target set way back in 2012 and the political resonance remains high, as the achievement of such will be considered a key highlight of the 100th anniversary of the Chinese Communist Party in 2021. If Beijing were to achieve this objective, the 2020 GDP growth rate has to come in at an estimated 5.6%, at least.

We are watching the significance of meeting the target vis-à-vis the real challenges facing the economy in the long term. For one, the external environment has become difficult to navigate, not helped by the fact that China's rise on the global stage has attracted its fair share of geopolitical skirmishes. Should there be a repeat of the 2008 GFC stimulus, will that be a sign that Chinese leaders are willing to kick the can down the road in exchange for immediate economic and political wins?

We are also keeping an eye on the 20th Congress of the Chinese Communist Party, which will convene in 2022. The continuity of China's reform progress and overarching progress goals is highly dependent on the line-up of the members of the Politburo Standing Committee. There is no need to delve deep into politics here, but suffice to say, investing into China's real estate sector calls for a strong grasp of the political situation and recognizing the key figures and policies that could influence the dynamics of the property and capital markets.

The 14th Five-Year Plan (2021-2025) for China was deliberated and further refined towards the end of 2019, and it is scheduled to be approved by the top legislature in 2021. This Five Year Plan will be a blueprint of China's developmental goals for the next half decade and guides the policy actions of Beijing. For real estate investors, the plan is critical, as there will be indications as to where new growth areas will be, and how investors should position their strategies and allocate their capital accordingly in the medium term.

Among others, the 13th Five-Year Plan had a large focus on economic restructuring, property destocking and initiating reforms on deleveraging, which culminated in a period in which we saw limited land supply for real estate activities, as well as greater control over access to property financing and controls over outbound capital flows. We believe the development plan for the next five years will not be a significant deviation from the previous period, but with an added emphasis on the delicate balancing between growth and mounting fiscal risks. Market reforms will continue and the focus on people will be paramount, to ensure that the mandate of the party remains endorsed through social and economic progress.

Imminent threats

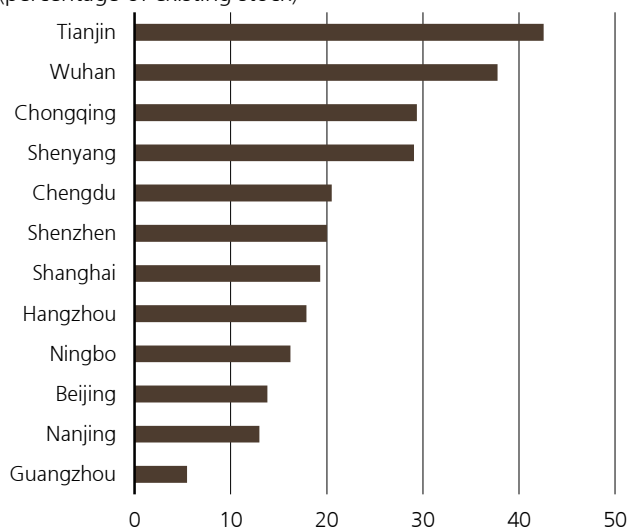
After a staring contest that lasted almost an entire year, the stand-down in trade tensions offered some late but welcomed relief to Asia markets, and of course to China. The fundamental issue here is not who emerged victorious – the US or China – but whether the next few years will see the same circumstances being repeated. The impact of the trade tensions were fully felt throughout China, with anecdotal evidence suggesting that smaller industrialists bore the brunt of the slowdown in export demand.

The Chinese industrial sector suffered in particular, but the collateral impact was definitely felt in the office sectors across China, as corporate sentiments took a hit, resulting in pullback in office absorption. In markets such as Tianjin, Wuhan and Chongqing, where office vacancies were already trending high, the situation is even more dire.

The upcoming US presidential election may be a factor in how the trade rhetoric between the US and China could evolve in the next few years. Then again, the race for dominance in the global hegemony is never straightforward, and this threat of another trade dispute remains very real.

Figure 10: Office vacancy rates as at 2019

(percentage of existing stock)



Source: CBRE (as at 4Q19), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

How can China pull off the Houdini act of rebalancing the economy while juggling multiple reform goals without triggering a hard landing? The truth is, the economy is still grappling with possible defaults and local government debt exposure, while the general property sector remains bedridden. These are chronic ailments that will take time to heal, and there is no silver bullet. The impact of a slowdown in real estate extends beyond that transmitted through headline growth figures. On the financial end, many developers were and are still highly leveraged, and the sustained slowdown in property sales meant a disruption in their traditional model of churning and selling, which is affecting ability to meet loan and interest repayments (particularly so for pure-play residential builders).

Coupled with a growing reliance on shadow banking, especially for builders with limited access to bank lending, this is a ticking time bomb waiting to explode. Given the high gearing ratios of most developers, compounded by a weaker RMB, onshore and offshore debt servicing remains a big challenge. Any high profile default would definitely ignite a domino series of liquidity pullbacks, possibly crippling the economy. And this is why a slowdown in the real estate sector extends its tentacles deeper than what we can perceive from the outside.

As much as household consumption has multiplied on an absolute basis over the last two decades, making China one of the largest consumer markets in the world, its share of China's GDP has been very low. In the whole industrialization cycle of China since the early 1990s, its share of consumption to GDP has always been generally lower than that encountered by other major Asian economies, which already had been through this same stage. Consumption growth has also lagged behind that of investment. The key culprit in the case of the unwilling Chinese consumer, as most will easily point to, is the extraordinarily high level of savings in China. The concept is straightforward: if you don't save, you spend.

As former US Federal Reserve Chairman Ben Bernanke noted recently in March 2016, China's fiscal policy going forward should aim to support emerging social safety nets, covering the costs of health care, education, and retirement. Indeed, increasing income security in China would promote consumer confidence and consumer spending. If reforms to the healthcare, hukou system and the social security do not make significant strides in the next few years, the drag on consumption could weigh down on the already bloated retail sector, which is struggling with a meaningless decentralized retail space glut as well as direct competition from e-commerce.

Opportunities in the next five years

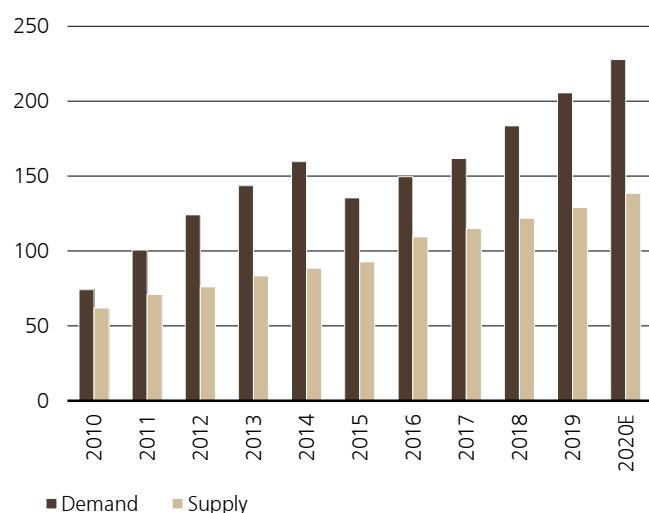
As we formulate our views on the Chinese real estate space, we constantly remind ourselves that much of the country's growth has been driven by local initiatives and developments over the years rather than by Beijing. There is an obvious heterogeneity among provinces, cities municipalities and counties, from the cultural aspects to the administrative features. In general, we are strong believers in the logistics story in China. However, aside from the widely acknowledged ecommerce and middle class drivers, there are opportunities in other specialized segments of the industrial sector.

China wants to transform from a large manufacturing country into a strong manufacturing country. That is no mean feat, as major developed economies such as Germany, the US and Japan are the incumbent dynamos in global manufacturing, particularly for high end products. As early as in 2006, China released a Medium to Long-Term National Plan for Science and Technology Development (2006-2020) that focused on the upgrading of the industrial base, and which was repeated in the 11th Five-Year Plan (2006-2010), the 12th Five-Year Plan (2011-2015) and the most recent 13th Five-Year Plan (2016-2020), all of which have consistently emphasized the need to develop strategic emerging industries and move towards medium-to-high end manufacturing.

On 19 May 2015, China's State Council published a new blueprint for the manufacturing industry termed "Made in China 2025", which set the goal of joining the league of manufacturing superpowers by 2025, moving up the rankings by 2035, and consolidating China's position as a manufacturing giant by 2049. We estimate that more than 70% of existing industrial workshop space has been developed by state-owned developers and local governments before and during the 2000s, a high proportion of which do not meet the current institutional demand in terms of build specifications. Anecdotally, we see a significant supply gap in the high end industrial workshop space, and with the government's push for industrial upgrading, we are at the early part of the cycle for this real estate segment where developers with land-banking capabilities and a strategic focus on tenants in high value added industries will be able to ride this wave.

Over the past decade, alongside the rapid growth of Asia's economy, food consumption patterns have evolved, and the demand for food-related cold chain has increased exponentially. China still lags behind Europe and the US in terms of the cold-chain infrastructure. With greater awareness of food safety, the demand for perishable goods brings with it a real need for modern cold chain facilities. The growth of B2C e-commerce in recent years, especially in the food segment, is a growing trend that looks to be unabated in the near future. Looking within the logistics sector in China, we believe a key market gap has emerged in the more specialized area of cold chain logistics. We estimate that China's cold chain capacity is underdeveloped and aging, with more than half of existing cold chain facilities above the age of thirty years. According to the China Federation of Logistics and Purchasing, more than 80% of the refrigerated warehousing in China has not been built for logistics purposes.

Figure 11: China cold storage demand and supply
(million cubic metres)



Source: ResearchInChina (China Cold Chain Logistics Industry Report 2016-2020), UBS Asset Management, Real Estate & Private Markets, February 2020

To most, the mention of China conjurs up images of the French Concession in Shanghai or the Tiananmen in Beijing. However, South China is home to some of the largest and most economically vibrant cities in China, in particular Guangzhou and Shenzhen, as well as prefecture-level cities such as Dongguan and Foshan. The Pearl River Delta economic zone led the way in China's opening up in the 1980s, and many cities in the region rode on South China's reputation as the manufacturing base of the world. With that economic success in the pocket, the region has made a gradual and successful shift towards the services sector, and the tertiary industry now contributes a higher proportion of GDP, which is in line with China's long-term nationwide goals.

Beyond the manufacturing sector, more importantly, consumerism, proliferation of electronic commerce and solid residential population growth are driving the underlying demand for commercial real estate. The development of the Greater Bay Area is expected to further enhance the economic growth and connectivity for South China, especially Shenzhen, and we believe real estate investors will do well to increase their exposure to South China.

Japan

(Updated 25 March 2020 to reflect postponement of 2020 Tokyo Olympic Games.)



Signposts

- 2020 Tokyo Olympic Games
- Integrated resorts outcome (around 2020/21)
- Government policies on demography



Threats

- Abenomics after September 2021
- Vulnerabilities in the financial system showing
- Greying population is a perpetual risk



Opportunities

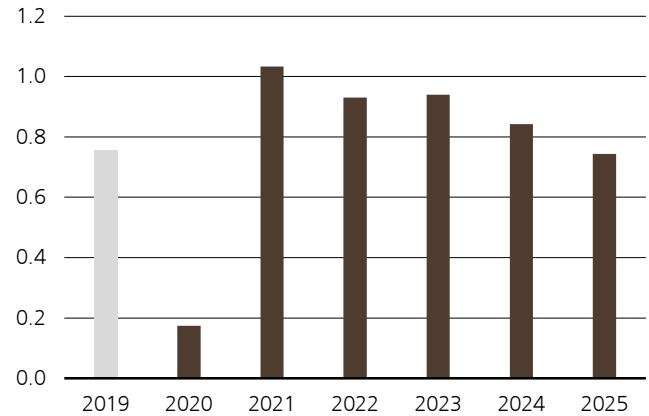
- Multi-family sector backed by fundamentals
- Value-add strategy in commercial real estate
- Japan hotel sector not just an Olympics play

Hitting a speed bump

In early 2019, it became clear that Japan was in the midst of its longest post-war economic recovery as 2018 rounded up seven consecutive years of GDP expansion. Businesses have received a boost from the expansionary fiscal and monetary policies under Prime Minister Shinzo Abe, as seen in the rise of the Bank of Japan (BoJ) Tankan survey indices to multi-year highs and the growth of corporate profits, which then had flow-through effects to the labour market where improved prospects lifted the jobs-to-applicants ratio and drove the unemployment rate down to the lowest in close to 30 years. Some positive momentum still continued into early 2019, but even the world's third largest economy cannot escape the punitive effects of the US-China trade war. Exports have been on a declining streak and business investment weakened, and where household consumption held up before, that too saw a sharp contraction in 4Q19 due to the consumption tax hike in October as well as the disruption from Typhoon Hagibis.

Figure 12: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
 Note: Data for the period 2020-2025 are forecasts

Signposts we are watching out for

How the near-term outlook pans out depends very much on how the government responds to the COVID-19 outbreak, both in terms of any potential stimulus measures as well as efforts to contain the spread of the virus. This is particularly apt given that the greatly anticipated Tokyo 2020 Olympic Games – originally due to be held from July to August – have, following much deliberation, been postponed to 2021.

There will be much added uncertainty in the near term and Japan will undoubtedly bear a large logistical cost; nevertheless, there have been and will continue to be positive economic benefits when the Olympic Games do eventually take place. Early positive effects to date had been the increase in construction investments, not just for the building of facilities for the Games, but also the construction of hotels and the improvement of transport infrastructure.

The other positive economic benefit would have been increased tourist inflows. Since the advent of Abenomics brought about the depreciation of the Japanese yen, the relaxation of certain visa requirements and an increase in the number of inbound flights have led to a record high number of visitor arrivals – reaching 31.9 million in 2019. The Tokyo Olympics would have been the key event to enable the government to reach its target of 40 million visitors in 2020, but with COVID-19's global reach and China being Japan's biggest source of tourists, that figure is likely to be unattainable in the short term.

In the longer term, the government has been seeking to grow tourism as a pillar of Japan's economy with plans to eventually hit 60 million visitors by 2030, and having realized the untapped potential of the many destinations outside of the Tokyo Metropolitan Area, the focus has turned to the promotion of regional tourism. Aside from capitalizing on its rich history and culture and diverse natural environments, and organizing events such as the Osaka 2025 World Expo, another purported revenue-generating strategy that seems to be materializing is Japan's plan to legalize casino and gambling.

In mid-2018, lawmakers passed a law to allow the construction of three Integrated Resorts (IRs) in a bid to revitalize the economy, and at least eight areas – namely Yokohama, Osaka, Wakayama, Nagasaki, Hokkaido, Chiba city, Tokyo and Nagoya – have indicated their interest to play host. Given the economic gains that have been witnessed in other countries which have legalized casinos, including Macau and Singapore, the desire by regional cities to host the IRs is understandable as they battle the longstanding challenges of a shrinking population and slowing economy, but the strategy is not without its fair share of controversy. With the IRs slated to open in 2025, the next few years will see how the casino plan will play out, and which cities will end up hosting them. The boost to the national economy is significant, and the IRs will also be a shot in the arm for the commercial real estate sector.

With Japan being the country with the world's largest proportion of its population over 65, demographic policies will undoubtedly be in the spotlight over the medium term. The past few years have seen the government tap the often-overlooked labour pool of women and the elderly, and the plan to get more of such workers to join the labour force has borne fruit – those aged 65 and over, and women aged 25 to 54 were the two largest contributors to employment growth since 2012. With the labor force participation rate already on an uptrend where it recently hit an 18-year high of 62.6% in October 2019, the government has turned to another target demographic to engage – foreigners. To be sure, efforts to recruit foreigners have already been underway with the Abe administration relaxing certain rules since 2015.

On 1 April 2019, a notable immigration reform took effect with a new "Specific Skilled Worker" (tokuteigino) visa status created for skilled foreign workers in Japan. The scheme aims to bring in more than 345,000 skilled migrants to Japan over the next five years. As a departure from existing schemes, foreign workers can now be considered regular employees and there is a path to permanent residence status. With foreign workers making up only about 2% of the labor force, there is room to raise this in the medium term, although much depends on the government's ability to create policies that can successfully maneuver local sensibilities.

Imminent threats

With much of the recent optimism in the markets and the economy owing to the policies put in place under Prime Minister Abe, the end of Abe's term as the leader of the Liberal Democratic Party and as Prime Minister of Japan come 30 September 2021 will be a key event to watch. What will become of Abenomics after September 2021?

Indeed, what will the future of Japan's political leadership look like once the nation's longest-serving leader steps down, given that Abe has emerged as a stabilizing force after a string of revolving door prime ministers?

While there have been some clear wins from his now-seven years in office, other pledged agenda items, such as Abe's goal to deliver structural reforms, will be left to his last two years in office, a Sisyphean task given that some of these reforms are regarding complex issues such as pension, healthcare and corporate reforms. Will the new administration continue with a similar focus, or will we see a reversal of the progress that Abe has put in place?

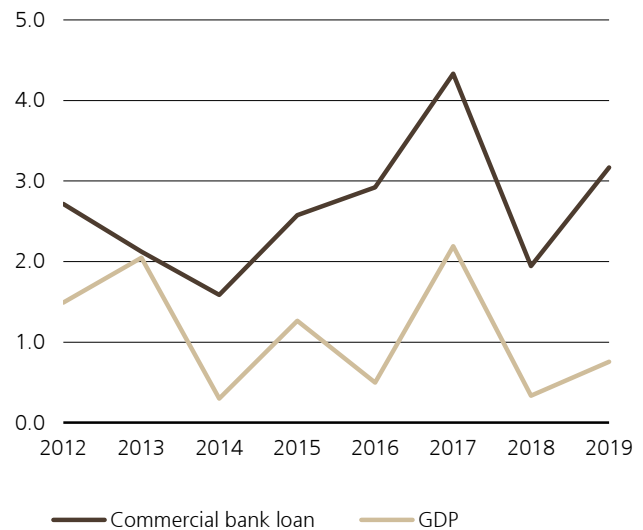
While speculation has begun, it is impossible to predict the answers to these questions at this stage where there is still so much uncertainty and near-term challenges on hand. But investors will be remiss to lose sight of the changes that will soon take place in Japan's political landscape.

A risk which has arisen out of the BoJ's unprecedented ultra-easy monetary policy is that of increasing vulnerabilities in the financial system. It is not just that the accommodative monetary conditions have led to credit growth rising at a faster rate than GDP (Figure 13), but the broader issue is that the prolonged period of ultra-low interest rates as well as the structural challenge of an aging and shrinking population are starting to hurt the profitability of banks, leading to narrower margins and prompting financial institutions to take greater risks in lending and securities investments. Loans to the real estate sector have risen, and taken as a percentage of GDP, the BoJ estimates that total levels have exceeded that of the previous bubble period and thus warrants some attention.

The third risk we want to highlight is one that is well-documented and an issue we have already alluded to in earlier paragraphs – that of Japan's greying and shrinking population. Not to belabor the point, but this is a real risk to Japan's economy because it necessarily reduces the potential output of the country by virtue of definition. Other challenges that will arise are the implications for fiscal expenditure, given that spending on healthcare and social security will inevitably increase while the tax base will shrink, which would place further pressure on Japan's already high public debt levels and potentially lead to stress in the bond market.

Reductions in productivity levels are typically also compensated by advances in technology, and Japan is already pushing ahead in this area with its world-leading position in its production and use of industrial robotics. In the logistics sector, much of the outperformance of some facilities can be attributed to site locations which are in strategic proximity to residential catchments or transport nodes, which allows for the easier hiring of workers in a shrinking labor market.

Figure 13: Credit vs GDP growth
(%, YoY)



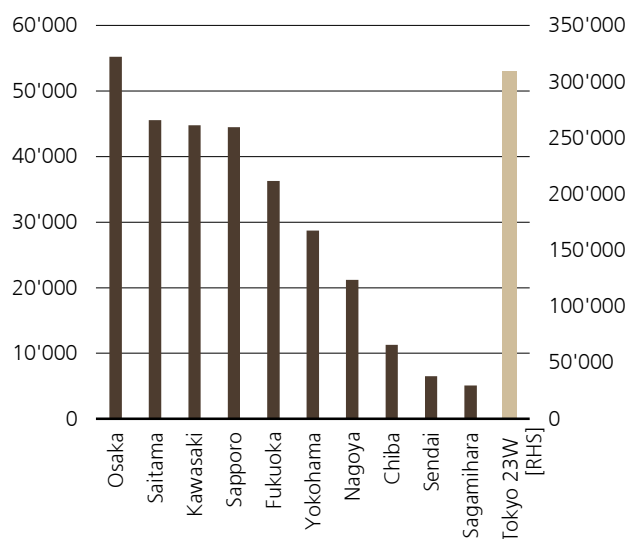
Note: Latest commercial bank loan data from IMF as at 2018. 2019 figure estimated by Oxford Economics. Source: Oxford Economics, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

Opportunities in the next five years

We think that Japan remains one of the most viable multi-family rental markets in APAC, supported by fundamental demand drivers. While the nationwide population is indeed decreasing, the employment and education opportunities that tend to be higher in economic centres continue to draw migrants to the major cities in Japan, resulting in positive net migration and population growth at the city level (Figure 14).

Migrants into the cities also tend to be younger than the overall population being of job-seeking age, and would have a greater likelihood of turning to the rental market for their accommodation needs – as evidenced in the homeownership rate in Tokyo, which at 46% is much lower than that for overall Japan at 62% (which is already lower than other major markets including China and Australia) and points to a deep tenant pool of multi-family tenants that exists in the major cities. Other factors such as the rise of single-person households due to changing demographics (aging, growing number of divorcees etc) and the policy thrust to bring in more skilled foreign workers into Japan, will likely add to this demand pool.

Figure 14: Japan cities with positive net-migration
(Number of people, 2015-19)



Source: Statistics Bureau of Japan, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

The supply side of the multi-family equation also suggests that upcoming stock remains at balanced levels. Changes in inheritance tax laws indirectly led to a temporary spike in housing starts in Japan since 2015, as high net worth individuals and families began to build rental housing on the land that they hold in a bid to reduce the eventual tax burden. Since 2017, however, housing construction starts for multi-family have been falling consistently, suggesting that the initial euphoria surrounding the inheritance tax laws has now subsided.

Data from the Association for Real Estate Securitization shows that occupancy rates for the major cities of Tokyo and Osaka have been consistently above 90% over the past 10 years, and since early 2013 the range has been even tighter at above 95%. Rental volatility is also lower than that of other asset classes, and going forward, we think that the stable, defensive nature of the Japan multi-family sector coupled with a favourable demand-supply dynamic would present investment opportunities there.

Japan's office markets have displayed strong performance in recent years, where vacancy rates have compressed to extremely tight levels. Tokyo's office market has proven to be particularly resilient in spite of the high levels of supply, with demand supported by the optimism among businesses (which has understandably faded in light of recent developments) as well as legislation to shorten working hours that has led to increased occupier demand. Vacancy rates there have fallen to a record low of 0.7% – the lowest among major APAC cities, according to CBRE data – with similar trends taking place in

Osaka, Nagoya and Fukuoka. While these trends have prompted investors to seek out prime office assets in core markets, we think a case can be made for opportunities in value-add offices instead.

It is estimated that approximately 80% of small and mid-sized office buildings in Tokyo were built more than two decades ago. With more than 90% of office tenants in Tokyo being small and medium companies employing less than 30 employees, the demand-supply dynamics favors the value-add of existing class B office assets. According to Savills data, Grade A vacancy rates in the central five wards of Tokyo was 0.2% as at 4Q19 while Grade B was 0.1%. To that end, the demand profile underpins a structural opportunity to capitalize on the aging profile of office assets in the form of asset enhancements and value creation. Furthermore, new supply in recent years have been predominantly in the Grade A space while that for Grade B space has received limited new stock. Concerns of an economic downturn are likely to affect the Grade A sector to a larger extent, with Grade B offices likely to remain more resilient.

The affirmative theme underlying the Japan hotel sector has not gone unnoticed by investors, especially in the last few years. While many investors will consider this a play on the Olympic Games, akin to what happened in Beijing and London previously, our view on the hotel sector is structural. With the COVID-19 virus making its presence felt globally in the hospitality sector, it might be easy to dismiss the hotel sector in Japan entirely. Yes, the hotel sector has always been a cyclical one, and that volatility and risk has always been reflected in the higher return requirements. And not many investors are able to embrace a hotel strategy, especially core investors.

The one important difference between Japan and many other Asia markets is that the bulk of accommodation demand in Japan is in fact driven by the domestic traveler. To put things into perspective, the demand for accommodation by domestic travelers is almost six times that of international tourists, and has been stable in the last few years. Because of the competition in terms of pricing and asset sourcing in the Japan hotel market, we believe the astute entry strategy for investors looking at the hotel sector is in fact in value-add and development of limited service hotels, with a predetermined forward exit by locking in an operator, thus mitigating against the leasing risks often encountered with development projects. The Japanese hotel sector is on the cusp of an unprecedented structural transformation. With the possible emergence of more hotel focused REITs and the entry of institutional investors, hotels are fast becoming a mainstream and liquid asset class in Japan.

Hong Kong



Signposts

- Chief Executive election 2022
- Greater Bay Area interim milestone 2022
- Lantau Tomorrow Vision reclamation 2025



Threats

- Real estate's over-dependence on China
- Change in investor attitudes towards HK
- The emergence of Shenzhen



Opportunities

- Office decentralization theme continues
- Selective opportunities in Industrial
- Non-discretionary retail has resilient traits

Stability called into question

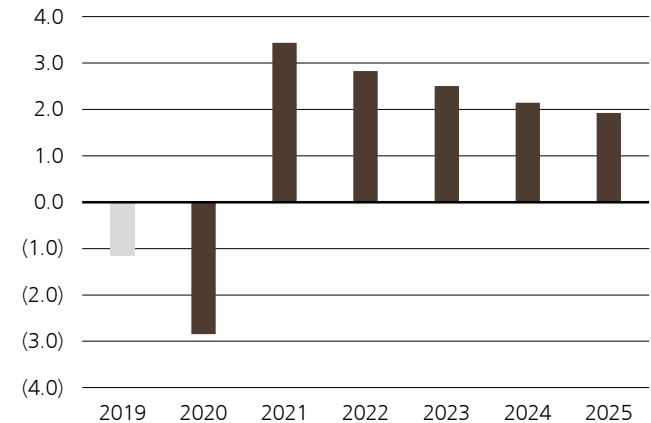
To put things into perspective, Hong Kong's economy shrank by 1.2% in 2019, the first contraction in 10 years. In 2009, Hong Kong was badly affected by the fallout from the GFC, and that was a financial event which many countries were not spared from. The situation now is slightly different.

On the external front, the trade tensions in 2019 between China and the US put Hong Kong between a rock and a hard place. The long-term outlook is shaped by developments in China, but it is fully exposed to the shifts in global financial and trade issue which remains rickety still. Yet, domestic problems were what really dragged down overall economic performance in 2019, as anti-government protests intensified towards the second half of the year, weighing on tourism and consumption.

As they say, it never rains but it pours. As Hong Kong residents struggled to come to terms with daily life being disrupted by frequent mass protests and violence, the COVID-19 outbreak occurred. Market observers have commented that the onset of the virus coincided with a winding down of the protest movement, likely as concerns over the contagion made many stay off the streets. Overnight, face masks that once symbolized the dogged determination of the protest movement now represent unity, health and safety for the city. Then again, it could well be a Trojan horse, because the negative effects of the pandemic, if uncontained, may deliver a fatal blow to the already fragile economy. Moreover, there is no guarantee that the domestic unrest has been resolved, as political groundswell may stir to life again.

Figure 15: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
Note: Data for the period 2020-2025 are forecasts.

Hong Kong remains joined at the hips with China. Economic linkages with mainland China will be the most important catalyst for ongoing prosperity in Hong Kong, but we also note that heightened political risks from rising social tensions are increasingly a key point of concern for investors. It is apparent that politics will affect the real estate market in Hong Kong more than anything else. From sentiments to capital flows, right up to underlying property demand, the mid term consideration for real estate market participants is stability.

And that stability, or the certainty of Hong Kong's position in the regional and global hegemony, is what will make or break the real estate markets in the next half decade. That said, Hong Kong's economic fundamentals remain sound on account of a well-regulated financial and banking sector, strong fiscal position and a tight labor market that will support wage gains. And these are unlikely to change drastically in the next five years.

Signposts we are watching out for

There are a few milestones that are meaningful from now till 2025, and could have immediate and longer-term repercussions on Hong Kong and its real estate sector. We encourage investors to watch the local political situation closely. The 2019 Hong Kong district council elections saw the 'pro-democracy' camp score a resounding victory over the 'pro-establishment' group. The significance is not so much a change in governance or laws as district councilors have no direct governing powers, but rather an endorsement of the sentiments at the grassroots level.

The Legislative Council election is due to take place by September 2020, with up to half the seats determined by popular vote. What we are watching, is how the outcomes of these elections may influence China's stance towards Hong Kong. Further down the line, the next Chief Executive election in 2022 will throw light on whether moderation and conciliation can occur, or whether persistent public anger and confrontation are here to stay. The next five years are critical to investors, particularly long term asset owners, as political developments now have a more than outsized impact on real estate values and performance in Hong Kong.

The Greater Bay Area (GBA) is a strategic regional cluster consisting of nine cities in the Pearl River Delta and the two special administrative regions of Macau and Hong Kong. In a blueprint released by the Chinese government in early 2019, the next milestone for the GBA will be in 2022, by which time there should be a vibrant cluster facilitated by infrastructure and the seamless exchange of people and services. The GBA blueprint highlighted Hong Kong's importance as the region's financial center, international financing hub and offshore RMB center. Real estate investors will be monitoring this development closely, as any diminishment of Hong Kong's role in the GBA master plan within the next five years could adversely influence its global positioning in the long run, affecting the commercial real estate market.

Between 2014 and 2016, the Hong Kong government conducted a deep-dive into the city's development strategy, which culminated in a report (Hong Kong 2030+). Notably, the findings concluded, amongst others, that Hong Kong is facing a land deficit, which has been reflected in soaring residential and commercial property prices. In late 2018, the government announced a long-term plan (Lantau Tomorrow Vision) to reclaim more than 1,700 hectares of land along East Lantau. Preliminary projections have factored in the provision of approximately 43 million square feet of commercial floor space.

Also, the reclaimed land will be able to accommodate close to a million people in about 400,000 residential units. Does Hong Kong need another third CBD after Central and Kowloon East? While slated to be underway only from 2025, with fiscal affordability being a real concern for now, investors should be monitoring the key developments for this project, as that could alleviate housing (and social) woes and improve the affordability problems faced by many commercial tenants.

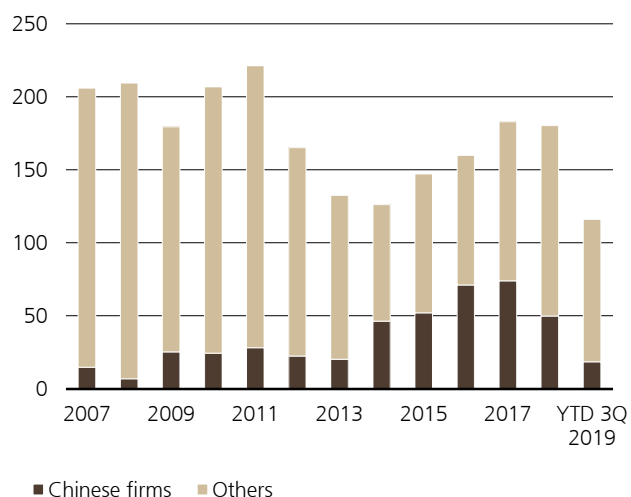
Imminent threats

The medium term risks that we have identified in Hong Kong pertain to political and social issues, and much of the looming threats derive directly from China's actions.

The Hong Kong commercial real estate's dependence on mainland China is a double-edged sword which is hard to unweave. The relevance of Hong Kong as an international office market has been increasingly thrust into the limelight, as the occupier profile of the office sector shifted from a clear dominance by multinational firms towards a market driven by growing demand from Chinese mainland occupiers. This growth in demand from mainland China firms, particularly from the finance sector – which accounts for over a third of all reported CBD demand in the past three years – has played a key role in pushing up prime office rents in Central. In the past year, 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. In the retail sector, 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 2019.

Figure 16: Hong Kong CBD office take up
(million sqm)



Source: PMA (as at October 2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

From capital might to capital flight, changes in investor attitudes could trigger a sustained dull in the real estate sector and liquidity. 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 in the next three to five years. However, if the political environment worsens after the COVID-19 outbreak eases off, there could be a medium term downside exposure to capital outflows, which may ultimately affect property valuations. This would be felt in all sectors, from the luxury residential markets to the office sector, bearing in mind the offshore asset allocation by mainland Chinese investors.

Shenzhen is the closest competitor that can challenge Hong Kong's position in the region. And there is a real and emerging chance that the Chinese government will frame the political crisis, if unresolved, as the catalyst to speed up the development of Shenzhen in the next five years. Already, the GBA plan puts forward Shenzhen as the key hub for innovation and technology, and it is no exaggeration to say that Shenzhen is the leading city in China in this area. Shenzhen's GDP overtook Hong Kong in 2018, partly because of its booming high-tech industry.

With a bustling stock exchange and growing ecosystem of growing companies, and if Beijing diverts more resources towards the targeted development of Shenzhen, it could well dilute Hong Kong's appeal to multinationals and Chinese companies. Obviously, Hong Kong has had a massive headstart, and its legal and business frameworks render it more conducive to investors. For now, we are putting forward this risk as one that is unlikely to materialize overnight but could very well be a reality in the longer term.

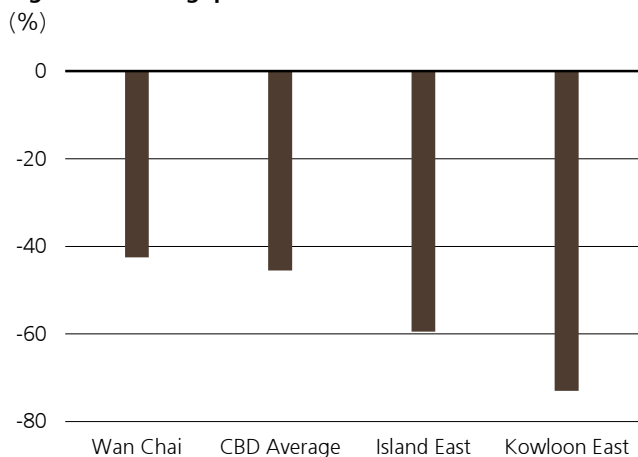
Opportunities in the next five years

We emphasize that Hong Kong's venerable position in the global real estate market has been built up over many decades. Amidst the long term challenges, there are still ample opportunities that real estate investors should pay heed to.

The decentralization theme and the growth of the second CBD in Kowloon East continues to play out in Hong Kong. We continue to be believers in the long-term viability of office decentralization in Hong Kong, whether it is occupiers making a lateral shift from the prime Central area to the less congested sub-markets of Causeway Bay and Island East (especially with infrastructure improvements such as the opening of the Central-Wan Chai Bypass) or occupiers moving off Hong Kong Island altogether into Kowloon.

With vacancy rates extremely tight in Central, that theme should continue to gather pace in the next few years, despite the expected weakening of occupier demand. 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 and rents will continue to hold up in the near term after the impact of the COVID-19 outbreak is accounted for. Looking beyond 2025, investors should have a clearer view if the decentralization story will play out even in the Lantau region. For now, affordability concerns will continue to drive occupiers towards Kowloon East.

Figure 17: Rent gap to Central submarket



Source: PMA (as at October 2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

The sequel to the 2009 industrial revitalization plan was announced by the government in late 2018. The renewed scheme allows for extra floor area in the conversion of entire industrial buildings built before 1987 into commercial purposes. The government ropes in the private sector in the renewal of old districts and aging industrial buildings, while allowing investors to take advantage of lower costs compared to acquiring new land. Obviously asset enhancement on existing industrial assets is not without challenges. The limitations on power loading and mechanical structures often mean that there may be additional costs related to such conversions, which may tilt the economics the other way.

All said, this is a window of opportunity for many asset owners and investors to identify areas where the greatest upside in conversion value may manifest. Also, approximately six million sq ft of logistics space could be removed from the Hong Kong market over the next five years which is expected to exacerbate an already tight warehouse market. Healthy demand from 3PL companies supported leasing activity, driving overall warehouse vacancy rates to a four-year low.

Low vacancy is underpinning the defensive qualities of dominant shopping centers. While we have concerns over Hong Kong's dependence on China and tourism in the prime retail segment, we are optimistic on the long-term performance of suburban retail. The dense urban layout of Hong Kong means that retail offerings are mostly a stone's throw away from most residential areas. One will almost never need to travel more than 15 minutes in order to dine at a proper restaurant or to, for instance, purchase some basic groceries.

In a country where living space is limited, retail takes on the role of the "third place", after the home and the workplace. What this means is that the need for disruption on physical retail by e-commerce is less flagrant in Hong Kong. Investors can focus on non-discretionary retail, such as suburban malls which are supported by wide residential catchments and non-discretionary domestic spending. Execution-focused investors will be able to tap on pockets of opportunities in Hong Kong in the value enhancement of poorly managed suburban malls, of which the intrinsic value was never truly unlocked.

Singapore



Signposts

- Industry Transformation Programme progress
- General Elections by April 2021
- Completion of infrastructure projects



Threats

- Goods & Services Tax hike by 2025
- Retail subsectors in City Hall / Marina Center
- Short land tenure across Industrial sector



Opportunities

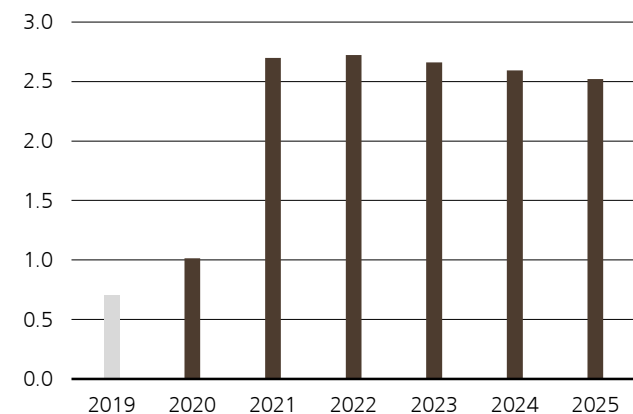
- Business parks and selected industrial segments
- Hotel sector to break out (after COVID-19 blip)
- Decentralization will create new options

Transformation calls for patience

It was not too long ago that the city-state marked its 50th year of independence, with much to celebrate amid the economic progress made within half a century. But as Singapore enters middle age, there is also a keen awareness that the coming years will not be as easy to navigate, with the low-hanging fruits already plucked and the country in advanced stages of growth.

Figure 18: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
 Note: Data for the period 2020-2025 are forecasts.

2019 ended with GDP growth of 0.7% YoY¹, the weakest rate of growth since the GFC – except this time, there wasn't a major one-off trigger such as the meltdown of the financial sector; instead, it was a protracted trade war, the broader

¹ Based on preliminary estimates

trend of rising trade barriers, and a period of synchronized stagnation in the global economy underpinned by a lack of demand drivers that are proving to be worrisome, given that these issues take longer to overcome. The services sector was fairly resilient, supported by the finance, insurance, and business services sectors, while the construction sector pulled ahead, buoyed by public sector infrastructure works.

Signposts we are watching out for

We are focused on the government's multi-sectoral, multi-year plan to restructure the economy, in a bid to ensure it remains ready and able to tackle the challenges of increased volatility. The next few years will be key in gauging the progress of Singapore's economic restructuring plans, encapsulated in the SGD 4.5 bn Industry Transformation Programme. This is a high-level initiative first introduced by the government in early 2016 to facilitate efforts to raise productivity and innovation levels across 23 industries that make up over 80% of the country's GDP.

Over the past few years, the Industry Transformation Maps (ITMs) started to take more shape and form, and while all 23 ITMs have been launched, the results are mixed. Sectors such as the financial industry have adapted better, but industries that comprise of more small and medium-sized enterprises have yet to make that leap from strategy to execution, especially when they remain bogged down by the perennial bugbears of high labor costs, skills shortages and foreign worker restrictions. Over the next five years, industry will continue to look to government for more clarity on policies and more understanding of and support for business needs, all of which are critical in enabling companies to automate, digitalize, upskill and regionalize.

The next five years will also see several major infrastructure projects, some of which were conceptualized decades ago, inch closer towards completion. Of these, the longest in the making is the Circle Line, the fourth of Singapore's mass rapid transit train lines and one which connects the three other rail lines to the city. Proposals for this rail line first began in the 1990s, with construction and the first operations taking place in the 2000s. With 30 stations now up and running and travel times between some parts of the island reduced by as much as half, the rail line will finally come full circle by 2025 when the loop will be closed with the completion of three new stations.

In addition, the sixth rail line in Singapore, the Thomson-East Coast Line, will also be progressively completed between 2020 to 2024, and work on the North-South Corridor, a 21.5km long route for vehicles and pedestrians, will also take place. All these are part of the Land Transport Authority's (LTA) long-term plan to improve connectivity across the island and reduce traveling times, with the ambitious aim of compressing 90% of peak period journeys to within 45 minutes by 2040.

In the medium term, greater connectivity would eventually unlock the economic potential of certain decentralized parts of the island. A case in point is Paya Lebar which has been rejuvenated in recent years thanks, largely, to the opening of the Circle Line. Equally importantly, this would also ease the strain on the country's infrastructure, particularly as the population has grown from 2 to 5.7 million in 50 years. What would be the hot-button issues that will require a policy response in the next five years? There would be no shortage of opinions about this as the country heads towards its next General Election (GE), which must take place before April 2021.

As it is, in November 2019, Prime Minister Lee Hsien Loong already called the upcoming GE a "high stakes" one, particularly as it comes at a time of leadership transition within the ruling People's Action Party and a growing trend of the erosion of trust in political leaders seen around the world. To complicate things, the COVID-19 virus started to spread in the region in early 2020, becoming the black swan event that is likely to weigh on a barely-recovering economy.

But an unintended effect is that this has now become a test for Singapore's fourth-generation (4G) leadership, according to political observers, and while it is still relatively early days, the Republic has so far received plaudits for its handling of the crisis, from implementing contact tracing to its upfront communication with the public. In this time of uncertainty, certain topics might be skirted for now, but bread-and-butter issues such as costs of living, job security and inequality will likely come to the fore again the closer the country draws to the GE.

Imminent threats

One of the clouds looming on the horizon had been the planned Goods & Services Tax (GST) hike, which was announced in early 2018. Given the COVID-19 outbreak, the government has decided to delay the implementation of the tax hike, but affirmed that it would still take place by 2025 in light of rising healthcare and other spending needs. The recent experiences in Japan with its consumption tax hikes in 2014 and 2019 have shown that such a move tends to be followed by a temporary contraction in GDP.

While Singapore's experience has not always been the same (GDP continued to expand after its last GST hike in July 2007) nor is its economy directly comparable with that of Japan, there are legitimate concerns that a GST increase would have a negative impact on household spending and the economy, particularly as growth is now slower and the global environment uncertain. In the real estate space, the sector most likely to be affected would be retail. Some upside could come from the broadening of the tax base to include online purchases and digital services, although this is unlikely to have

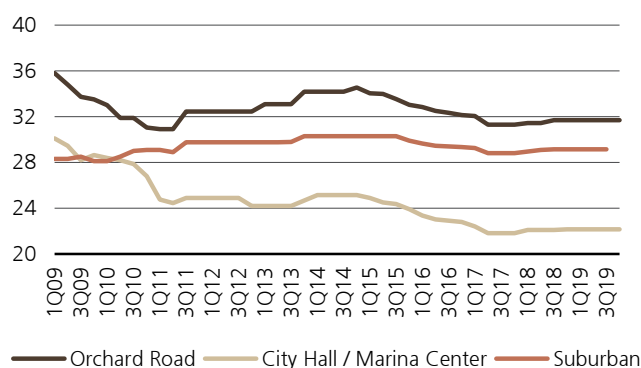
a major slowing effect on the structural trend of rising e-commerce.

By and large, the Singapore retail sector appears to have weathered the worst of the global retail downturn. And while pipeline supply is tapering off, it might be too early to deem that the whole sector is out of the woods – landlords may have been implementing experiential elements to increase footfall and dwell-time but there is limited evidence to show that this has translated into sales.

The road to recovery could thus be a long one, with most caution reserved for shopping centers in the Downtown Core or City Hall/Marina Center area. Of the three broad areas that the retail market is categorized into – the prime Orchard area, City Hall/Marina Center and the Suburban shopping malls – it is the City Hall/Marina Center area which seems to lack the draw of the prime shopping belt and the residential catchment that supports the suburban malls.

This is evident in retail rent performance – average rents in City Hall/Marina Center used to be higher than that of the suburban area but that relationship has been overturned since early 2010, and while Suburban rents have largely remained range-bound, that for City Hall/Marina Center have continued falling and is now roughly 12% below its previous peak in 4Q14, the largest correction among the three sub-markets (Figure 19).

Figure 19: Singapore average shopping center rents (SGD per sq ft per month)



Source: CBRE ERIX, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

The final risk to highlight is that of the short land tenures in the industrial property market. This has been an issue for the investment market ever since authorities halved the maximum tenure for industrial sites under its land sales programme from 60 to 30 years in mid-2012. For eight years now, land sale sites have had either 20 or 30-year leases, and prime industrial properties with freehold or land tenures of 60 years and above

are scarce. This effectively deters investors from getting into the market, particularly amid the other challenges facing industrial property. Among these is tepid demand from industrialists in recent quarters given the weak global trade picture, with many firms using the current period to consolidate operations.

From a structural perspective, Singapore's manufacturing sector is changing – though it remains a core pillar in the country's economic strategy, it faces a cost disadvantage and thus has to move up the value chain, but this is a massive challenge with no easy executional pathways. The resurgence in new completions in 2020 and again in 2022 after only recently coming out of a multi-year supply glut further compounds the risks in the sector.

Opportunities in the next five years

Despite the challenges, we think that pockets of strength exist amidst a vastly disparate industrial landscape – in particular, business parks and high-tech industrial buildings. Business park space designed with flexible layouts, ancillary amenities, and good connectivity are still well-occupied and demand remains resilient. Singapore has also primed itself well to be in a strong position to serve high-value added manufacturing including the bio-medical, pharmaceuticals, aerospace and transport engineering sectors, and growth in these industries is expected to support demand for good quality factory space. Investors might find themselves keen to play these themes, but the challenge is finding good quality assets which also have a long-enough land tenure at a reasonable enough price.

might benefit from the upside of a favorable demand-supply situation. Tourist arrivals in Singapore have put on a strong showing over the past 10 years, and while there are ebbs and flows as is expected in the hospitality sector, the trend is undeniably upward.

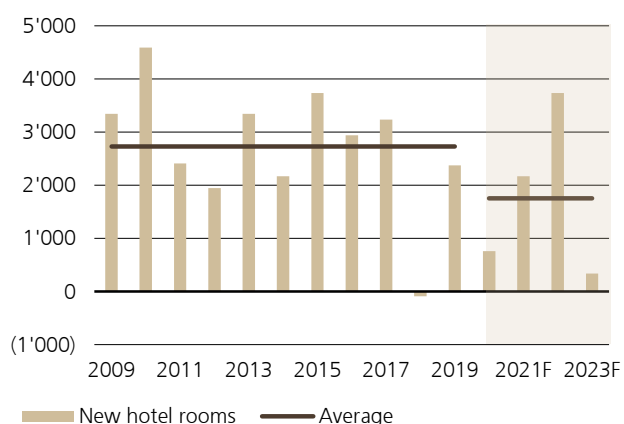
Part of this is no doubt attributed to the rise of China as an economic superpower and the resultant growth of the middle class, but that highlights the opportunities that come about when a destination country manages to capture a period of rapid growth in a source market – which is exactly the strategy that Singapore is seeking to replicate and adapt for the growing middle class in Southeast Asia. In addition, the Singapore Tourism Board (STB) is also actively working on efforts to cultivate the appeal of the city-state as an attractive tourist destination.

Between 2009 and 2019, tourist arrivals grew at a CAGR of 7.0% while supply of hotel rooms have barely kept up with a CAGR of 5.0% over the same period. Occupancy rates are thus well-supported, with the standard average occupancy rate climbing to 87.1% in 2019, higher than the 10-year average of 83.8% according to STB data, and revenue per available room (RevPAR) was similarly above the historical average.

Going forward, pipeline supply of hotels remains limited with the stock of hotel rooms expected to grow at a CAGR of 2.4% between 2019 and 2023, half the levels of the past 10 years (Figure 20). Barring the expected short-term blip from COVID-19, this should further support the hotel market when visitor arrivals start to recover in the medium term.

Figure 20: Singapore hotel supply

(Number of rooms)



Source: Singapore Tourism Board, URA, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

Despite the near-term threat posed by COVID-19, we think that the long-term structural picture is still supportive of the hotel sector in Singapore. Investors with a higher risk appetite

On the back of the growth of the transport infrastructure network, we think this will benefit decentralization in the medium-term. Areas like the Jurong Lake District, which has already been positioned as Singapore's second CBD, will see these development plans inch closer to fruition with improved connectivity supporting 'work, live and play' formats. As part of the government's long-term land planning strategies, otherwise unfamiliar areas such as the Punggol Digital District and Paya Lebar are undergoing transformation that will see previously-underdeveloped areas become more vibrant and current.

Will they eventually become established enough to draw commercial occupiers away from well-established areas like the CBD? Decentralized rent levels are generally competitive and asset quality is on par or even better than many aging Grade A and B building in the CBD. For many, that is still too far-reaching an idea, but we think the possibility is that these decentralized areas could eventually become decent core plus options for investors, bearing in mind that the compact size of Singapore renders most locations very near by time proximity.

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