

Real Estate Outlook

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Curiouser and *curiouser*



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The rabbit hole runs deep and
investors must stay prepared.



Economic indicators point to a brighter than expected near-term outlook. However, weak business and consumer sentiments could negate impact from relaxation of social restrictions. Lower transaction activity reflects the increasingly cautious attitude of investors. Occupier performance may trend weaker in the new reality.

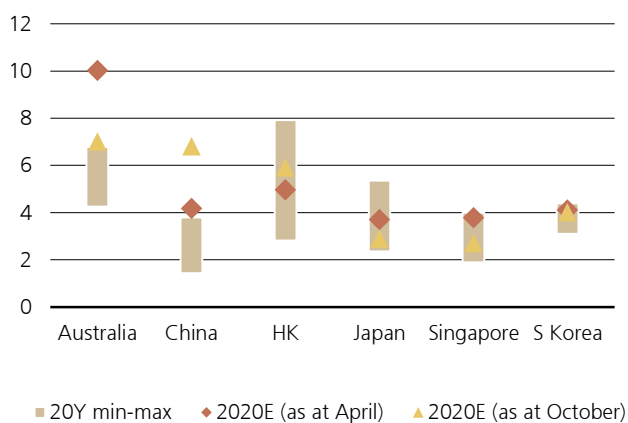
Real estate fundamentals – Navigating the rabbit hole

‘The rabbit-hole went straight on like a tunnel for some way, and then dipped suddenly down, so suddenly that Alice had not a moment to think about stopping herself before she found herself falling down what seemed to be a very deep well.

Down, down, down. Would the fall never come to an end?’

The much beloved classic Alice's Adventures in Wonderland, by Lewis Carroll, celebrates its 155th anniversary this year. As the protagonist Alice tumbles down a hole in pursuit of a rabbit, she enters a warped reality and gets lost in a realm of improbabilities. Nothing there remains the same for long, and not everything makes sense. In real life, as the world grapples with the COVID-19 pandemic, there are parallels to be drawn between Alice's wonderland and the current world we live in. Obviously the economic rabbit hole we are in is deep, and the landing could be painful, as already evident in the global malaise. But even as we slip down the rabbit hole, real estate investors in APAC do have the relative benefit of the time to look for a softer landing.

Figure 1: Unemployment rate (estimation, %)



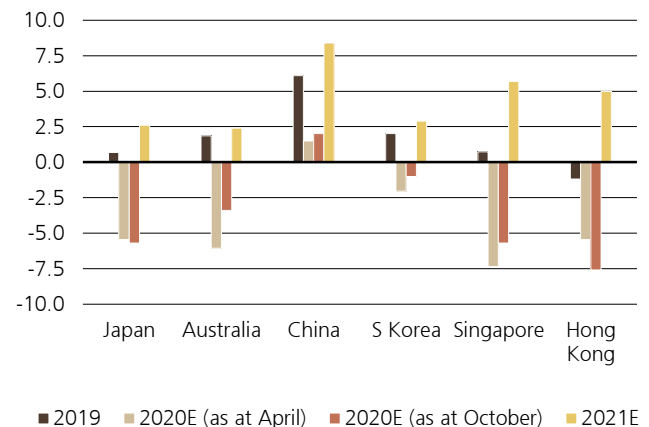
Source: Oxford Economics; CEIC, as at 19 October 2020

APAC was the first region to take the hit from early waves of infections. Arguably, most of APAC has arrested and slowed down the contagion through early intervention and by displaying unyielding will to lock down entire economies for periods of time. It is not yet business as usual in Asia, even as some economic indicators do point to better than expected upgrades in our near-term outlook. In the previous editions of this report, we have consistently focused our attention on the unemployment rate, as it is indirectly related to underlying demand for commercial real estate.

At the onset of the outbreak in April 2020, unemployment rates in 2020 were forecast to surge to and beyond 20-year highs in many countries (see Figure 1). In the case of Australia, that figure was estimated at a sobering 10-13%. As the impact of the pandemic became clearer, coupled with forthcoming support measures by governments, the APAC labor market calmed down steadily.

According to the IMF in October 2020, effective lockdown measures taken early during an epidemic may lead to faster economic recovery. These medium-term gains offset the short-term costs of lockdowns, leading to positive overall effects on the economy. This is precisely what is happening in APAC. New Zealand, Vietnam, China, Singapore and Japan are but a few of the successful case studies of a first-in and first-out model of virus containment. There are inevitable second or even third bouts of outbreaks, such as in the state of Victoria in Australia or Beijing in China. However, these examples have again been suppressed rather decisively. Most APAC economies are forecast to see positive growth in 2021, with China leading the way at 7.6% (see Figure 2). While a low base effect certainly enhances the optics of the uptick in near-term economic growth, it is important to highlight that this improvement in outlook is increasingly based on actual and progressive economic results.

Figure 2: GDP growth (estimation, annual, real %)



Source: Oxford Economics; CEIC, as at 12 October 2020

Even though the past quarter looked more promising, it is too early to rest on one's laurels. APAC needs the global economy to improve in lockstep. Most support measures are tapering towards the end of the year and government coffers are finite. The rabbit hole is long and winding, and the landing is hardly in sight. Pressure will pile up in the coming months if there is still no sign of medical progress. While the descent may appear to be less bumpy now, being prepared to break the fall and recover is important if APAC economies and real estate markets are to stand on their feet once again.

Retail

'I can't explain myself, I'm afraid, sir,' said Alice, 'because I'm not myself, you see.'

Retail sales performance in the key APAC markets saw only marginal improvement. According to Oxford Economics data, in Australia household consumption was a key drag as the savings rate shot up from 6.0% in 1Q20 to 19.8% in the second quarter of 2020. On a 3-month moving average annual basis, Australia's retail sales growth came in at 8.9% in August 2020, even as a resurgence of virus cases saw the state of Victoria effectively locking down in July. China saw healthier retail sales performance, recording a 0.5% YoY growth in August, the first time this metric was positive this year. We can expect the boost from the Golden Week holidays to show up in consumer spending in the next quarter. Markets such as Hong Kong and Singapore are more reliant on inbound tourist expenditure because of the small domestic consumer base, and they continue to see weak retail sales.

In the near-term, the lack of inbound tourists and weak retailer sentiments will nullify the relaxation of social restrictions as domestic consumers continue to tighten their purse strings. We are forecasting a drop in prime retail rents in the range of 6-10% in most APAC markets in 2020. Hong Kong will fare worse and is likely to end the year with rent levels at two-thirds of what it was in early 2020. The e-commerce assault on the sector is staying unabated and should intensify after the pandemic. We continue to prefer the barbell model in retail, favoring essential retail on one end and prime retail on the other end of the spectrum.

Office

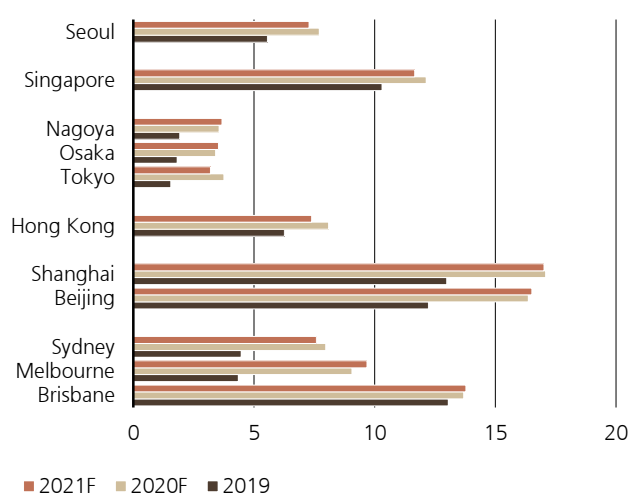
'I knew who I was this morning, but I have changed a few times since then' said Alice.

Occupier sentiments in the office sector are waning after holding firm for most of the year. Government rebates and concessions can only go so far to support occupancy costs and are not permanent. As the global economy continues to remain lethargic, businesses are feeling the pressure on their topline. To be fair, we have not seen abrupt corrections in prime office rents, but we do expect absorption levels to drop by more than 40% this year. Landlords are increasingly open to the idea of working hand in hand with tenants to offer mutual support with the aim of ensuring that occupancy rates do not fall off the cliff. Obviously, rents and incentives will have to be adjusted but in the mid to long-run, the post-pandemic leasing risk is much lower for landlords that are able to hold on to their tenants now.

We expect the Japanese office markets to be the most resilient in APAC (see Figure 3). Tight vacancy rates (less than 2.5%) and a limited supply pipeline put Japan in a good position, bolstered by Japanese corporates sitting on strong balance sheets.

Sydney and Melbourne have had a good run over the last few years, and affordability concerns on the back of a weakening business environment now threaten to be a key drag on their office markets. In the case of Shanghai and Beijing, whilst the pandemic resulted in some construction delays, development is still expected to be somewhat elevated in the next two years. Emerging decentralized locations compound the underperformance of the Chinese prime office segment, particularly in a prolonged period of poor business sentiments and a flight towards affordability.

Figure 3: Office vacancy rate (%)



Source: PMA, as at 22 October 2020

New-economy occupiers, such as those in the technology and media sectors, continue to display deep appetite for office space in the region. The growing hostility towards China's technology firms by the US and India is causing many Chinese technology behemoths to seek new pastures in the South East Asia region. That has set Singapore up nicely to benefit from its hub position in the region, even as overall rents continue to trend down. And indeed, just over the past few months, we saw the likes of Bytedance, Alibaba and Tencent expand their physical presence, with a few firms even basing their regional headquarters in the city-state. It is estimated that technology firms have absorbed close to 400,000 square feet of office space in Singapore in this year alone, and that the same level of demand is likely to be repeated in 2021 based on current enquiries.

Industrial

'If everybody minded their own business,' the Duchess said, in a hoarse growl, 'the world would go around a deal faster than it does.'

This statement cannot be true in today's globalized world. The world would go round *slower* if everyone and every country decide to keep to themselves. The underlying premise of the

logistics sector is the interlinkages between economies, consumers and businesses, no matter globally or domestically. While there appears to be a pivot towards de-globalization, supply chains are not disappearing totally. They are being redistributed and relocated, some domestic some regional. It is fair to say that the industrial sector is in a two-speed situation, where the trade and manufacturing segment is moving at a slower pace than the fulfilment and e-commerce segment.

Weak global demand is the overwhelming headwind for manufacturing and trade reliant countries. The pandemic distracted us from the Sino-US trade tensions that were felt badly across most of Asia in 2019 but have never really gone away. What COVID-19 did was to tilt the weight of the problem from the supply side (supply chain disruptions) towards the demand side. Regardless, the impact on industrialists in APAC remains negative. This puts a dampener on overall rent growth in the industrial sector in the near-term. Post-pandemic we can expect to see greater regionalization of supply chains, and even the on shoring of production. The latter probably will be more prevalent in countries with bigger domestic markets such as Japan and Australia, in fact increasing the demand for industrial real estate. Other countries such as Singapore will shift towards high value-add manufacturing that is not easily replicated.

The common view is that as consumption moves online due to social distancing requirements, that will effectively cement the role of logistics in *the new normal*. Will consumers continue to shop virtually after COVID-19? Probably not in totality, but the virus outbreak has been the catalyst leading to a greater adoption of e-commerce amongst the wider population. In Japan and Australia where e-commerce penetration is not deep by the developed world standard, untapped potential in the logistics sector is yet to be fully exploited even as investment interest has run ahead. In China, the consumer class group continues to swell and steep logistics costs due to transportation is expected to drive the demand for well-located infill sheds, even after ten years of phenomenal growth.

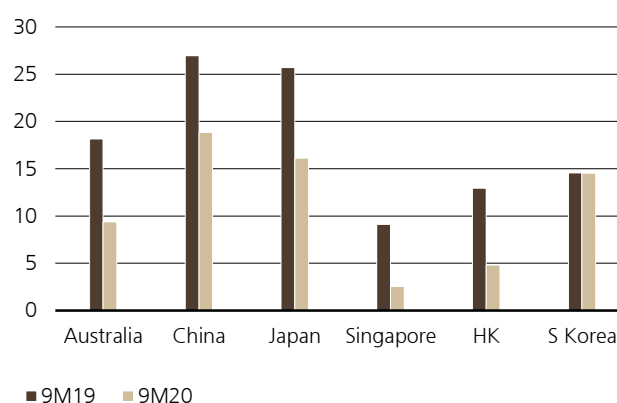
Capital markets – Running on the spot

‘It takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!’ said the Queen.

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell by approximately 37% YoY in 9M20 (see Figure 4). During the GFC, commercial property investments fell by more than 60% in a similar time period between 2008 and 2009.

The half-full mentality tells us that despite a turbulent year, investors continued to be active in APAC commercial real estate transactions with pricing staying rather firm. That says a lot about the prospects of and interest in APAC real estate. Given that due diligence and site inspections are mostly out of the question, it is heartening to still see major deals being concluded, even if some of these transactions were already underway before the pandemic. On the contrary, the half-empty attitude will remind us that the rabbit hole could extend deeper, and it will take a significant leap of confidence for investors to start underwriting transactions again. Thus, we could be in for a long period of investment latency. This is anyone’s guess.

Figure 4: Commercial real estate volumes (USD billion)



Source: RCA, as at 22 October 2020

South Korea has been the steadiest performer this year in terms of investment volumes. This is the vindication of how markets that can control the spread of the virus are able to garner the confidence of investors. Also, accounting standards reform in the insurance sector in Korea led to some insurers restructuring their real estate portfolios. This in turn saw fervent activity in the buying and selling of commercial property involving insurance companies.

Investment volumes in the Australian commercial real estate market fell by more than 48% YoY in 9M20, mainly due to deteriorating sentiments around the COVID-19 situation as well as enhanced lockdown measures in the state of Victoria. To that end, 3Q20 transaction volumes were down by more than 61% from the same quarter last year, as travel restrictions prevented investors from conducting any due diligence. Industrial and office assets with long WALE and strong tenant covenants were high in demand by core investors.

China saw a marked YoY increase in investment volumes in the second quarter of the year, which coincided with the period in which the outbreak was brought under control. In late June, however, a second wave of virus infections led to the reinstatement of lockdowns in Beijing and some parts of Hebei province. In part, that episode probably caused

investors to decide to adopt a wait-and-see approach, even though China proved its mettle in overcoming the virus resurgence. To that end, third quarter investment volumes plummeted by 51% YoY, leading to a 30% YoY drop in transaction activities in the nine months to September.

Investment activity in Japan was lackluster in the past three quarters, dropping by approximately 37% YoY compared to the same period last year. A closer examination tells us that the decline was led by sharp falls in retail and hospitality transactions. This can be attributed to owners deciding to hold on to their assets for another year in view of the postponement of the Olympic Games. What has been helping to prevent a massive write-off in malls and hotels is the government-led campaign to encourage domestic travel and spending, and that indirectly buys time for many operators as they hold on for positive news on the virus front.

In Singapore, the shortage of assets for sale resulted in transaction volumes falling by 92% YoY in 9M20. We expect that institutional investors and family offices will continue to cast their eyes over opportunities in the Singapore commercial property space. Commercial real estate investment activity in Hong Kong fell by 63% YoY in 9M20. We are hearing of greater interest in older office developments as well as warehousing facilities. The return of mainland China investors will be much awaited in the next few quarters.

Strategy viewpoint – Japan's telecommuting experiment

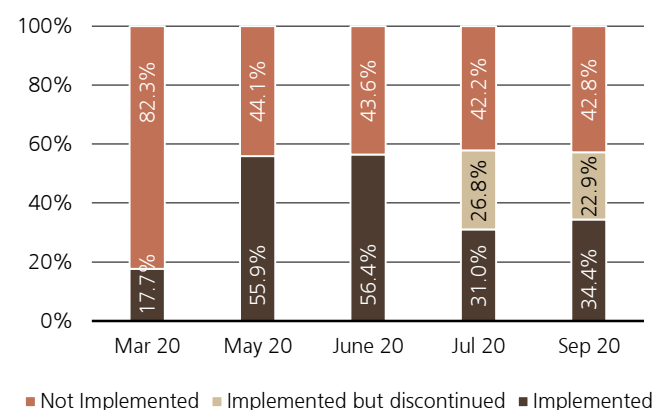
'But it's no use going back to yesterday, because I was a different person then.' said Alice.

Office markets globally are bracing themselves for the structural impact of remote working that will persist even after the virus episode is behind us. The new normal appears to be a reduction in office space requirements as companies and employees alike adapt to working from home. Japan is no exception; major employers such as Fujitsu are already rethinking existing office footprints in the longer-term. While headlines like these captivate the imagination of the futurist, the case in Japan is less straightforward. Fundamentally, we agree that the pandemic will boost the acceptance of working from home in Japan. That is only to be expected, especially as commute timings can be as long as three hours (both ways) for many salarymen who do not live near the CBD in cities such as Tokyo. However, it is more complicated than that.

There is a general reluctance amongst Japanese companies to adopt telecommuting protocols. During the peak of the pandemic when a state of emergency was activated, we saw almost 56% of Japanese firms entering into some form of remote working arrangement, up from the 18% before the

pandemic (see Figure 5). However, as the situation started to be brought under control, almost half of the firms that had remote working arrangements discontinued them. As at September 2020, that ratio had stabilized at 34%, just double the share of March 2020. The telecommuting experiment seems to have come full circle.

Figure 5: Telecommuting: Share of businesses in Japan



Source: Japan Ministry of Internal Affairs & Communications, Tokyo Metropolitan Government, as at 22 October 2020

There are many reasons why there is a pushback against telecommuting. For one, SMEs make up close to 90% of Japan's companies and the costs of remote working (infrastructure and productivity loss) are felt more strongly in these smaller outfits. Secondly, Japan is arguably a high-tech nation with traditional preferences. For instance, fax machines and hanko seals are used extensively in daily life, and the value of physical interaction is a top priority in the society. Thirdly, while the technology, finance and education sectors are the fastest adopters of remote working, they make up only 9% of the Japanese economy. In contrast, manufacturing and wholesale retail contribute more than 35% of Japan's GDP, and these are the sectors that are the least capable of implementing telecommuting given the nature of these businesses. Lastly, average home sizes in Tokyo are less than a fifth of that in the US and Australia. Working from home may not be the most desirable situation for most Japanese households.

All said, we are not suggesting that the Japan office sector is immune to the structural wave of telecommuting. No office market can go back to the way it was before COVID-19. In the case of Tokyo, if just a third of companies implement some form of remote working for their employees, our back of the envelope calculations estimate that this could translate into almost a 5% drop in office absorption from March 2020 levels. There will be some weakness in office occupier performance, but that will not move the needle too much. The key risk is that the pandemic drags on for longer than expected, and the corollary of that will be a permanent altering of mindsets and attitudes towards remote working, even in a culturally seeped society such as Japan.

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