

Real Estate Outlook

Asia Pacific – Edition 4, 2019



Rise in yield spreads
to spur investment interest

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The APAC economy continues to rely more on domestic demand as fiscal policy response kicks in. A downbeat mood is starting to affect office demand although markets are still supported by tight vacancies. The performance of industrial real estate is boosted by restrictions on land use. While sales volumes are falling, investment interest is likely to remain strong as yield spreads increase.

Real estate fundamentals

Bracing for a long winter

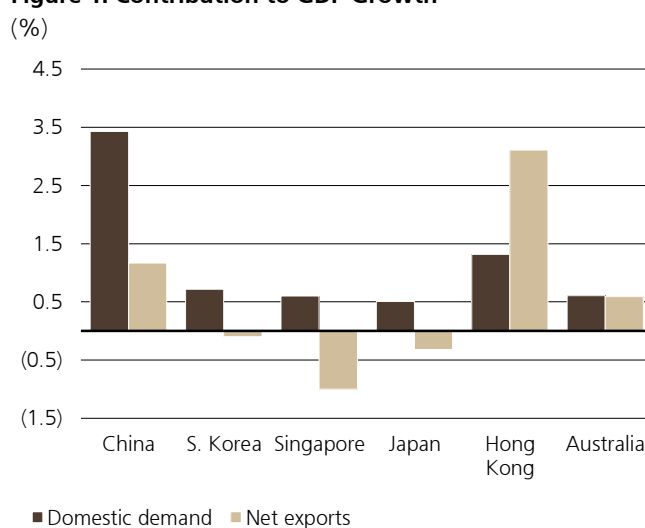
As we head into the last quarter of 2019, it has become more evident that the APAC economy is slowing down. While the situation is far from crisis proportions, there is a growing acceptance that economies in the region should brace for a long winter, heralded not just by the US-China trade conflict, but also the electronics down-cycle, Japan-Korea dispute and growing political tensions throughout the globe. GDP in China and Australia softened to the slowest pace of growth in a decade in 2Q19, while Hong Kong has entered into a technical recession as its GDP contracted on a quarter-on-quarter (QoQ) basis for two straight quarters. Unsurprisingly, weakness is mostly led by the external sector with exports contracting in most markets in 8M2019, with the exception of Australia where exports benefited from an increase in commodity prices. In contrast, domestic demand has emerged as a resilient pillar of support (Figure 1).

Private sector consumption has held up¹ well in 2019 (see Figure 1). This is partly due to a still-tight labor market where employment remains at high levels. In theory, this is supposed to result in rising wages which should then have trickle-down effects on consumption. However, structural changes in the labor market (such as the rise of temporary workers, masked underemployment, etc.) are turning this theory on its head. Furthermore, the muted macro outlook is leading to weakening business sentiment which curtails the willingness and ability of corporations to raise wages. In addition to other idiosyncratic factors, such as the newly implemented sales tax hike in Japan and the protests in Hong Kong, consumer sentiment has taken a hit and households could be holding back on spending in anticipation of tougher times ahead.

In the absence of any strong demand drivers from the private sector, the buck passes to the public sector to stimulate, or at the very least, provide a backstop to economic performance in the region. Central banks have already taken the lead in this aspect. Early in October, the Reserve Bank of Australia cut its cash rate to an historic low of 0.75% – its third reduction this year. Amid the disruption from the anti-government protests, the Hong Kong Monetary Authority also lowered interest rates for the first time since the GFC, while the Monetary Authority of Singapore reduced the slope of the trading band of the Singapore Dollar Nominal Effective Exchange Rate for the first time in three years. The People's Bank of China has also loosened monetary policy through a raft of measures including cutting banks' reserve requirement ratios and lowering lending rates, but given the simultaneous need to ensure that credit

growth does not get out of hand, Beijing has turned to fiscal measures such as cutting value-added and personal income taxes to spur demand. Indeed, credit concerns are not just confined to China. Market watchers are increasingly warning of rising corporate debt levels throughout Asia, precipitated by a decade of low interest rates and made worse by a waning profit environment. Further monetary policy easing will have its limitations and expectations are increasingly on policymakers to up the ante on fiscal support, which has thus far remained relatively subdued as lawmakers wait to see how the trade tensions play out.

Figure 1: Contribution to GDP Growth



Source: Oxford Economics, CEIC, 2Q19

Retail

Retail sales in Singapore and Hong Kong have been contracting every month since February 2019, with the latter being particularly hard-hit by the anti-government protests. In comparison, retail sales in China, Australia and Japan held up relatively well, although consumers in each of these economies are also grappling with their respective challenges such as muted wage growth and the recent fall in home prices in Australia, and the dampening effect of the tax hike in Japan.

Performance of retail property in APAC in 3Q19 was muted at best and while risks remain tilted to the downside for most cities, arguably none is as badly hit as Hong Kong. Not only are domestic consumers cutting back on discretionary spending as the intensity and ferocity of the unrest is maintained, but visitor arrivals have also started to drop much more significantly, falling close to 40% YoY in August. Prime retail areas – where the main protests have been taking place – have been more affected than suburban areas, although some of the malls there have not been spared.

¹ Contribution of net exports to GDP growth for Hong Kong is positive because contributions from imports fell to a greater extent than that of exports

Average rents in Hong Kong as measured by CBRE dropped 10.5% QoQ in 3Q19, and anecdotal evidence suggests that there are instances of more drastic rent reductions. Retailers are unlikely to undertake significant expansion plans until the situation improves and landlords begin to offer monthly leases as a way of coping with the circumstances.

Elsewhere in the region, leasing demand for prime retail areas is still relatively robust. In Tokyo, luxury brands, jewelry stores, cosmetic brands and F&B operators continue to show interest in the prime Ginza and Omotesando shopping stretches. In Sydney and Melbourne, leasing demand for CBD retail is coming from F&B brands, personal services such as retail banking, as well as health and fitness operators. But despite the leasing interest, softness in the economy still merits caution by retailers, which limits the ability of landlords to raise rents. Rents in these three cities were largely flat in 3Q19.

In China, policymakers sought to offset the effects of the trade war by introducing tax cuts to shore up consumer confidence, but it remains to be seen just how effective the measures have been against the broader backdrop of a weakening economy. The biggest challenge facing the retail market is likely to be the high levels of new supply that is due to be completed.

Industrial

Despite the worsening manufacturing and export momentum in 3Q19, the industrial sector'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 some cities, demand is also coming from food manufacturers amid a rising trend of food delivery services, and the need for the sector to centralize and automate due to high labor costs and retail rents.

In certain cities, competing uses of land have also reduced the amount of space available for the industrial sector, thereby providing an impetus for rent growth in places where stock has been tightened rapidly. One such city is Hong Kong, where the government relaunched the Industrial Revitalization scheme, prompted by the decline of the city as a manufacturing hub. Incentives such as an increase in the plot ratio have attracted investors to acquire ageing industrial buildings, driving down vacancy rates. Warehouse vacancy fell to a five-year low of 1.7% in 3Q19, with prime rents managing to rise 2.1% QoQ. Tier 1 cities in China also face similar changes in land usage, where there are growing restrictions on industrial land supply as the country transitions from manufacturing to services-led growth.

Australia, on the other hand, has seen industrial developments ramp up amid population growth and a government push for infrastructure development. Many of these new industrial buildings are speculative projects, but with pre-commitment leasing activity still strong, there has yet to be a situation of runaway oversupply. Rents in Sydney and Melbourne rose 0.4% and 0.8% QoQ, respectively.

In Tokyo, demand continues to be robust and despite a record quarterly increase in completions, rents in the prime Tokyo Bay area rose 0.9% QoQ. Pressure on occupier performance is higher in the outer regions of Greater Tokyo, where tenants have ample choices and are inclined towards sites which provide better accessibility and proximity to workers.

Office

A wave of caution is sweeping across most of the APAC office markets, and as has been the case in the other sectors this quarter, Hong Kong has been especially hard hit as the social unrest adds another layer of uncertainty to corporate real estate decision making. Demand from Chinese firms has slowed, partly due to the ongoing slowdown in China, and more recently a reluctance to further commit to real estate in Hong Kong, at least not until the near-term uncertainty clears up. Other occupiers have also taken a wait-and-see approach with their expansion plans, although this had already been the case due to surging office occupancy costs in the last few years. The saving grace is that total net absorption has not yet swung into contractionary territory. Nevertheless, there is a fear that more companies will give up space in time to come, leading to a rise in shadow space. Overall prime rents fell 1.5% QoQ, the strongest quarterly decline since 1Q13.

Occupiers are increasingly hesitant to take up more space in Singapore and net absorption fell to the lowest in 10 quarters, but limited new stock still resulted in Grade A core CBD rents rising 1.3% QoQ. A tight vacancy rate of 0.7% is similarly supporting the office market in Tokyo, where Grade A rents rose 1.1% QoQ in 3Q19. But after almost eight years of growth, the market is likely nearing the tail end of its rental expansion cycle with substantial new supply expected in 2020.

Cities in Australia are starting to approach their turning points as the rental growth momentum in Perth and Brisbane overtook that of Sydney and Melbourne in 3Q19. Rents in Melbourne were flat on the quarter, Sydney rose 0.6% QoQ, while Brisbane and Perth ticked up by 1.5% and 0.8% QoQ, respectively, amid a cyclical improvement in the secondary cities (which we wrote about earlier this year in our paper titled "*Approaching a turning point?*"). 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. On a year-on-year basis, however, rental growth in Melbourne and Sydney still exceeded that of Brisbane and Perth. Melbourne and Sydney could start to see some pressure with the expected increase in new supply over the coming year, particularly Melbourne.

Figure 2: APAC CBD office vacancy rates

(% of existing stock)

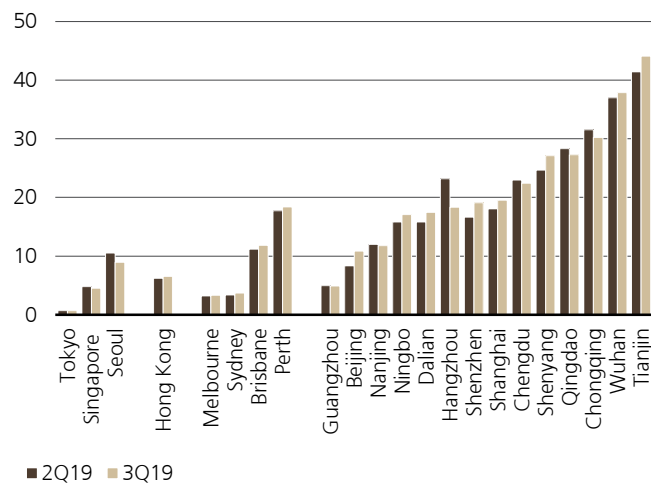
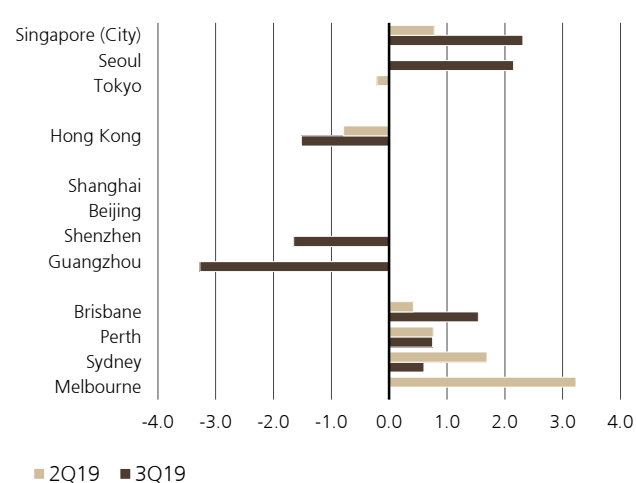


Figure 3: APAC CBD prime office rent growth

(% QoQ)



Source: CBRE, 3Q19

Capital markets

According to RCA, total transaction volumes of APAC commercial property fell 9% YoY in 3Q19. This is reflective of several concurrent trends: (i) a weak macro environment, (ii) elevated pricing levels, and (iii) certain markets entering late cycle, all of which resulted in increased prudence from the buyers' perspective. Investment volumes fell in most markets except for Singapore and China but this is not a particular concern given that 2018 volumes were at record highs and overall transactions in 9M2019 are still in line with 10-year averages.

Although it has a small market share in APAC, Singapore volumes grew by nearly 70% YoY. This is perhaps not surprising given the level of uncertainty in the global environment which prompts capital to seek safety, and the stability seen in the Singapore market could be an attractive enough factor to offset the tight yields and rich pricing. Major deals in 3Q19 include the SGD 1.6 billion acquisition of mixed-use project Duo by Gaw Capital and Allianz Real Estate, the SGD 655 million sale of 71 Robinson Road, and the SGD 548 million sale of Bugis Junction Towers.

China makes up a large share of APAC commercial real estate transactions, with the biggest deal concluded this quarter belonging to the USD 1.5 billion acquisition by Brookfield Asset Management of mixed-use project the Huangpu Centre in Shanghai. While capital outflows have been curbed by authorities, cross border capital has been eager to get in, with investors from Singapore and the US propping up most of the buying activity in 3Q19.

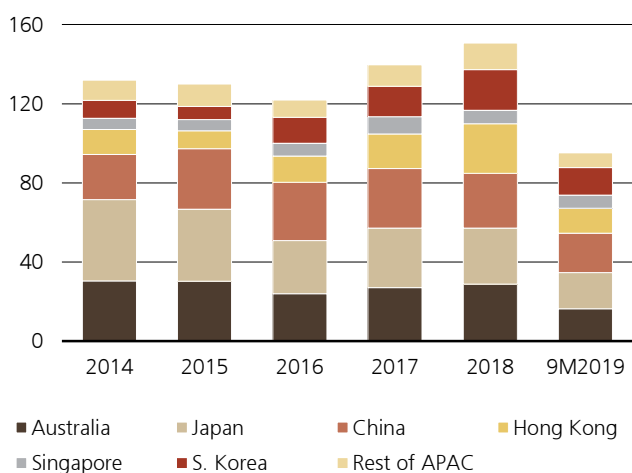
In Australia interest in the secondary cities of Brisbane and Perth has grown, although the lack of investable stock remains the limiting factor. 400 George Street in Brisbane managed to change hands for AUD 525 million, while most of the other major transactions in 3Q19 involved office assets in Sydney and Melbourne. Investor interest in Australia is likely to remain sustained given that cap rates there are still among the highest in APAC.

Several logistics properties changed hands in Japan, the most notable of which is Blackstone's USD 920 million acquisition from Mapletree of a portfolio of six logistics facilities in Greater Tokyo. Aside from this trade, Japan's investment market remains largely contained to domestic players, but rather than indicating a lack of interest, this is instead demonstrative of the difficulty of accessing stock in a market where assets are largely held by public and private J-REITs. There are growing signs of investors taking unconventional approaches such as strategic buyouts to acquire assets but these methods require a high level of sophistication and commitment and are unlikely to become commonplace.

Transaction volumes in Hong Kong fell over 40% YoY in 9M2019 but this is not alarming given that the volume in 2018 was at a record high and the total value of transactions in 9M2019 was in line with the 10-year average for full year investment volumes. Nevertheless, the full impact of the anti-government protests are likely to only be seen in the coming months given that the violence only started to escalate from July onwards. Mainland Chinese investors were noticeably absent from the investment market in 3Q19, marking the first quarter that they have not completed any acquisitions in Hong Kong in almost 10 years, according to CBRE.

With bond yields being driven down yet again by the accommodative stance adopted by global central banks, real estate yield spreads are once again looking attractive but we want to caution that property yields across most APAC markets are already at their lowest in in 10 years. While the vast amounts of dry powder looking for limited assets to invest in could still result in cap rate compression, we recommend that investors remain prudent in underwriting capital gains in their investments.

Figure 4: Commercial real estate transaction volumes
(USD bn)



Source: RCA, as at October 2019

Strategy viewpoint

With the recent high profile withdrawal of WeWork's planned public listing, the spotlight is once again on the untested co-working business model and what the implications are for real estate in the mid-to-long term. Fears about the co-working sector were renewed and questions raised about the viability of a business model which pairs long-term lease liabilities with variable revenue from short-term occupants, with the latter particularly tenuous and exposed to uncertainty in a weakening macro environment.

In our recent interactions with investors, there was a sense of skepticism about co-working, but in our view the emperor has always been wearing his 'new' clothes; i.e. it was not a new fault line raised by a few, but often deliberately ignored by many more. Part of what feeds this renewed fear is the reliance that office markets in APAC have come to have on the co-working sector as a demand driver, where take-up by the sector accounted for as much as ~30-40% of total office net absorption in cities like Singapore and Hong Kong in 2018².

The issue is that co-working operators are not expanding as a result of organic growth but are doing so in order to gain market share, which results in a situation of obligations that are unbacked by earnings. Thus far, landlords have been willing to sign on such operators, partly driven by the belief that the way people work is changing and partly by the ability of operators to pay high rents, but in all likelihood it is also due to a lack of options as absorption from the traditional space guzzlers like banks, shipping and commodities companies dried up. The credit risk of co-working operators as tenants is high, especially for many that have relied on venture capital cash and have yet to turn a profit. And, on the more extreme end, there exists a real risk that co-working operators become 'too big to fail' even if they default on their lease obligations, as market exposure to such a business model holds landlords to ransom.

Despite its detractors, we have to agree that the co-working sector has fundamentally changed the way that office users and owners are utilizing space. What used to be an old-school serviced office business has now created new, structural demand through the provision of supplementary offerings and clustering of networks, which are ever more important to new economy users. Furthermore, there are clearly companies who benefit from the flexible leases offered by co-working spaces, such as smaller enterprises and tech start-ups. As the economy slows, some traditional companies may also turn to co-working spaces as an interim solution while they wait and see how things turn out. To that end, we have even seen investors teaming up exclusively with co-working players in strategic partnerships to extract the premium from this structural change in how work space is being redefined.

The consolidation of co-working operators is something that will eventually happen across the industry, albeit gradually. That will allow for a few thriving and sustainable operators to stand out amid the currently fragmented landscape. Furthermore, many landlords have implemented measures to mitigate the risks while still getting exposure to the sector, such as by running a flexible office set-up on their own. And while WeWork might have been aggressive in spending, other operators which have been more disciplined in expenditure and diversified in revenue streams have shown that it is possible to be profitable.

The bigger implication, in our view, is that the pace of expansion by co-working operators is likely to slow from its breakneck speed. Office markets in APAC are likely to face a challenged demand picture, although this will be mitigated by tight vacancies in the region. More importantly, despite the rapid growth, co-working only accounts for about 2-5% of total office stock in the major cities in APAC; any fall out we see in the space will therefore likely be contained.

² Based on Colliers' estimates of 2018 take-up

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