Real Estate Outlook

Asia Pacific – Edition 2019

Stay hungry but not foolish

UBS

UBS Asset Management

Balancing defensive expectations and tactical strategies

This year remains a risk-on year that will test the nerves of real estate investors. We believe market risks cannot be skirted totally, but surely can be prepared for. In particular, investors should not let their guard down by underwriting excessive capital growth and it is inevitable that return expectations have to be adjusted downwards. All that said, the search for higher returns will continue to see investors put money into opportunistic plays and niche asset classes, although these may also serve as means to gain exposure to structural growth themes. We advocate taking a balanced approach – maintaining a defensive stance while remaining tactical in seeking and building on longer term opportunities in Asia Pacific.

Growth momentum to slow but support levers are broad
After two years of experiencing tailwinds from the strength of the global technology cycle, the mood across most of APAC has turned decidedly muted heading into 2019. The trade conflict between China and the US has clearly taken much of the flak for that.

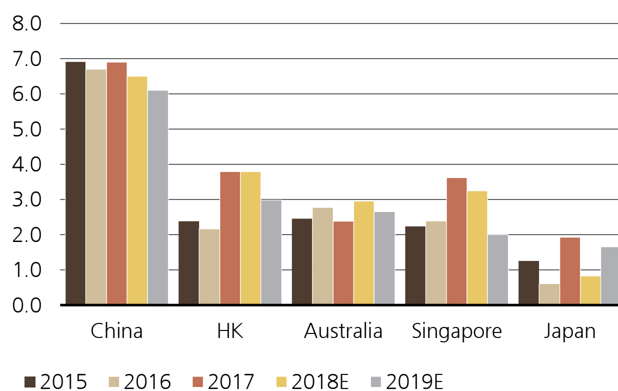
Nevertheless, there are reasons not to get too carried away with negativity. Chief of these is the fact that much of the economic softness, particularly in China, is nascent and manageable. 2018 saw the Middle Kingdom log its weakest GDP growth in almost three decades (see Figure 1). What is of note is that exports grew at a faster rate in 2018 (9.7% YoY) compared to 2017, which shows that trade was not the full reason for the economic slowdown (at least, not yet). Rather, it was the government's steering of the economy away from investment- and credit-driven growth which was the main factor. Recent data points suggest that the impact of the tariffs may be starting to take effect with the outlook for Chinese exports expected to be more moderate in 2019. Nevertheless, proactive measures to adjust monetary and fiscal policies will provide support to the Chinese economy in 2019.

Additionally, amidst the external headwinds, domestic demand is expected to pull the weight of growth in 2019, particularly for Japan. Prospects for consumer demand are not evenly optimistic across APAC, where housing market weakness could be especially detrimental to consumers in Australia (and to some extent, Hong Kong).

But nevertheless, policymakers in the region generally have the wherewithal to lend a hand to support growth – most have signaled some intention to implement fiscal measures, and with the lack of inflationary pressures as well as the US Federal Reserve sounding more dovish again, central banks are likely to remain relatively accommodative, ensuring that any interest rate increase is likely to be more gradual than initially anticipated.

Overall, growth momentum in APAC is likely to cool in 2019, but there are sufficient buffers to avoid a sharp downturn.

Figure 1: Real GDP Growth
(% YoY)



Source: UBS Securities Pte. Ltd., Jan 2019

APAC real estate round-up

Office: Watch the supply (or lack of)
The rental performance in the office market across prime cities in APAC has been largely positive over the last two years, with most markets enjoying strong net absorption and buoyant leasing demand. Rents were also driven by supply constraints, but heading into 2019, the dynamics look set to diverge. In Tokyo and in major Chinese cities, large amounts of space are expected to be completed. While this is likely to weigh on rents in China, the saving grace for Tokyo is that most of the upcoming space is already pre-leased, and coupled with a record-low vacancy rate. This still gives the Japanese capital some runway for rental growth. Cities in Australia have been witnessing stock withdrawals in the past few years but supply is slowly starting to trickle through starting in Melbourne, which is expected to cap rental gains in the city this year. Prime areas in Hong Kong have seen heady rental gains and look to be testing the limits of affordability while in parallel; the decentralization trend shows signs of gaining more traction.

Industrial: Long term structural drivers amidst a competitive supply landscape
Intuitively speaking, an expected cooling of trade as a result of rising protectionism should in theory be negative for industrial real estate but in reality, we are seeing the reverse take place. Demand for logistics space has been strong, as third-party logistics (3PL) providers and chain retailers continue to seek well located distribution units near major ports, railways and roads to facilitate the efficient delivery of goods. This testifies to the countervailing effect of the long term trend of growing e-commerce, which continues to play out across APAC. Other segments of industrial real estate are benefitting from government policy – in Australia, a push for infrastructure projects have given the construction sector a boost, which has in turn been taking up more industrial space. In places like China and Hong Kong, political will to derive greater value out of industrial land amidst changes in economic structure has led to conversion plans. This has resulted in limitations of industrial use and thus constricting supply. Despite these overarching themes, however, there are pockets of inefficiencies which exist in the industrial space given rising speculative supply levels as well as older stock becoming more obsolete. Investors should therefore be vigilant about asset selection.

Retail: Skip the middling middle and focus on extremes
The retail sector is still going through a period of regeneration, as retailers which have yet to adapt to changing consumer habits find themselves continuing to struggle. On the other hand, e-tailers which first captured the hearts of consumers online now find themselves with enough of a following to venture into the physical retail space and grow their brands. Improvements in the labor market have yet to translate into a tangible pick-up in spending and consequently retail demand. Signs of stabilization in markets such as Hong Kong and Singapore are now met with another roadblock, where moderating economic prospects are likely to weigh on consumer sentiment. Nevertheless, demand for prime retail space in key cities should still remain robust, supported by growing inbound tourists.

Capital markets: No drama

Data from Real Capital Analytics (RCA) shows that total investment volume into APAC commercial property in 2018 came off marginally from a year ago but is still close to all-time high levels at USD 163bn. Excluding multifamily apartments and hotels, however, total APAC investment volume into the traditional commercial asset classes of office, retail and industrial properties topped the record set in 2017 to hit a high of USD 146bn in 2018 (see Figure 2). This is in spite of market talk of rising interest in alternative asset classes amidst a hunt for yield, and testifies to growing capital flows into the more traditional and defensive asset classes of office, retail and industrial properties.

Appetite for office transactions industrial assets to remain robust
While office assets were still the mainstay of transaction volumes, industrial real estate proved to be the flavor of the year as capital flows into the asset class jumped about 24% YoY to hit a record high of USD 26bn. The question then becomes a matter of pricing as the average APAC industrial cap rate has already fallen to a record level of 6.0%, but given that the sector as a whole still offers higher yields than that of office and retail, it is likely that the appetite for industrial assets will remain robust. In a sign that investors are indeed seeking higher yields, investment volume into hotel assets rose 13% YoY, the second highest jump after industrial assets while the number of senior housing deals surged 89% YoY, albeit from a low base.

Hong Kong and South Korea were key destinations

In terms of investment destinations, the dynamics within APAC saw some changes in 2018. While China, Japan and Australia have been the recipient of the bulk of investment flows in the past few years, the tide shifted in favor of Hong Kong and South Korean assets in 2018, where both markets made up 17% and 14% of total APAC investment volumes respectively last year, which were record high market shares. Investment volumes into Hong Kong rose 40% YoY, making it a clear outperformer in APAC amidst a contraction in most markets.

The spike was driven largely by deals in 1H18 but the euphoria tapered off slightly in 2H18. Capital flows in South Korea were driven by domestic institutional investors increasing their real estate holdings. Investors may also have been attracted by the relatively higher yields there, but by end 2018, the gap between yields in Seoul and other APAC cities have also compressed such that the relative attractiveness of the South Korean capital might have reduced significantly.

Is this deja vu for yield compression?

Our view is that the much heralded reversal of the yield compression cycle will not happen in 2019.

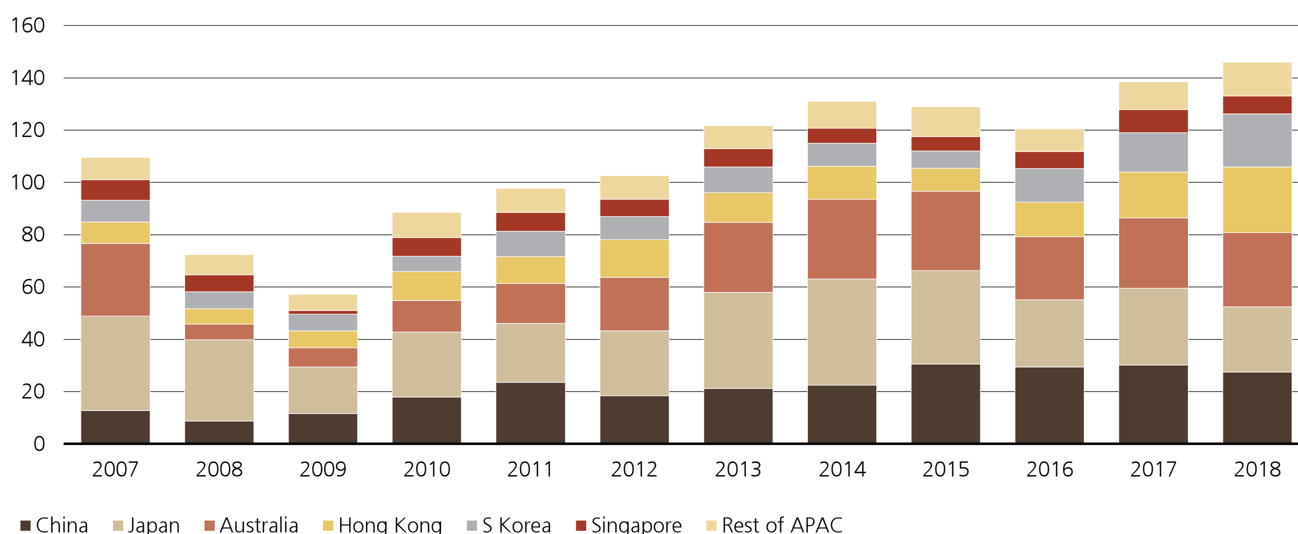
Instead, we expect this year to be a repeat of 2018, in which cap rates across APAC danced sideways amidst mixed messages on global interest rate normalization. Despite signs pointing to the end of the yield compression cycle, it is hard to declare that with much certainty, particularly given the dovish comments creeping back into central bank rhetoric and with the weight of capital continually defying expectations. In some markets, such as Australia, Japan and South Korea, the odds of monetary loosening have in fact moved higher than they were in the last year.

The market will eventually have to find a middle ground between buyer and seller expectations, and in the absence of any major shifts in cap rates, it is not inconceivable that investors will take a wait-and-see approach, with the result being much dry powder sitting on the sidelines, much as was the case in 2018. According to Preqin, global private capital dry powder surpassed USD 2tn as at June 2018, 18% of which is focused on Asia Pacific.

Nevertheless, yields are showing signs of hitting resistance levels and while they could remain low for some time, we still believe it is prudent not to underwrite significant capital gains given already rich pricing levels.

Figure 2: APAC commercial property investment volumes

(in USD billions, excluding land sales, hotels, apartments, senior housing)



Source: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Japan

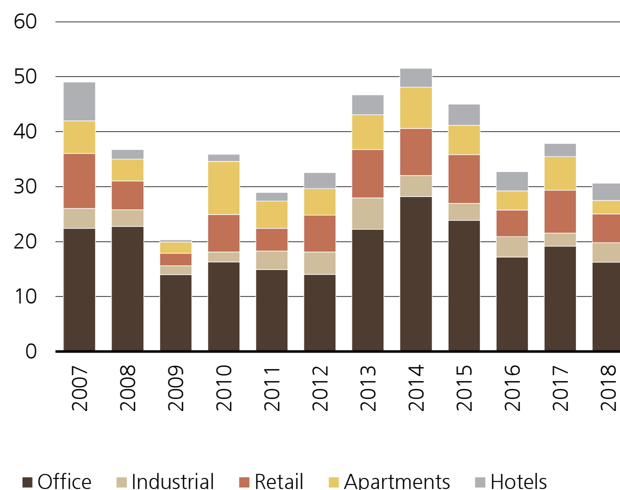
Japan is likely to be the sole outlier amidst a largely muted APAC region in 2019 as it is the only country where fortunes are expected to pick up relative to 2018. This is not because Japan is immune to the global headwinds; rather, 2018 has been an unexpectedly challenging year due to natural disasters and bad weather events which disrupted business activity. Despite this, sentiment is holding up with the December 2018 reading of the Bank of Japan's (BoJ) Tankan survey recording an improvement for all industries in September. This reflects an underlying confidence amongst the private sector, underpinned by still high levels of corporate profits and expectations that domestic demand could pick up. The latter is buttressed by a tightening labor market and healthy wage growth – the strongest in 21 years was recorded in June 2018. What will be of increasing importance going forward is the impending consumption tax hike, which is expected to lead to front-loaded domestic demand in 1H19. Not much is expected to change on the monetary policy front given that inflation is still expected to fall short of the BoJ's 2% target in spite of the planned tax hike. All in all, we expect Japan's GDP growth to improve slightly in 2019 although downside risks remain.

Tokyo's office market has proven to be particularly resilient in spite of the high levels of supply. Demand has been supported by upbeat business sentiment and robust corporate profits, and while new Grade A office supply is expected to remain elevated through 2020, pre-commitment levels are high with that of 2019 reportedly around 80%. According to CBRE data, the vacancy rate for prime Tokyo office has been declining since its most recent peak of 7.7% as at 2Q12 and in 3Q18, it stood at a record low of 0.9%. This partly explains the multi-year rise in prime Tokyo office rents – data from PMA shows that annual prime effective rental growth has been positive since 2012, and despite the well-extended cycle, further rental increases are expected in 2019 before growth moderates in 2020.

The retail market is enjoying some positive spillover effects from the improving labor market in Japan. In the near term, the consensus is that consumer spending will likely be sustained. What has and will continue to aid the retail market in Japan is inbound tourism which is expected to continue expanding, supported by a weak yen and events such as the Rugby World Cup 2019 and the 2020 Tokyo Olympics. Prime retail is likely to be the key beneficiary, but expectations should be tempered by observations that spending patterns of overseas tourists have also changed. Shopping centers will continue to be a mixed bag – some will continue to face consolidation of underperforming retail stores, which better positioned malls can ride out while reaping the benefits of having resilient, suburban demand.

Demand for logistics space worldwide has been riding on growing online shopping and Tokyo is no different. Despite the high levels of completion in 2018, vacancy rates rose only slightly as e-commerce and 3PL firms actively took up logistics space. Demand was strong but uneven – properties around the Tokyo Bay area which has good access to ports and transportation have low vacancies while inland areas have had a harder time filling up space. This trend is likely to continue in 2019, especially given that new supply is concentrated in the inland areas, but the saving grace is that projected completions is expected to be half the levels of 2018.

Figure 3: Japan real estate investment volumes
(USD billions)



Source: Real Capital Analytics, UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Data from RCA shows total transaction volumes into Japanese commercial real estate (excluding land sales) sliding 19% YoY to about USD 30bn in 2018 (see Figure 3). Domestic REITs, which have traditionally been the biggest buyers of assets, pared back activity slightly in 2018. The biggest contributor to the decline was the pullback in cross-border capital. This is likely a reflection of the rich pricing levels given the record low cap rates across the commercial asset classes. As a proportion of total transactions, more investments have been moving out of Tokyo into secondary cities in parallel with the hunt for higher yields. From a yield spread perspective, we think Japan remains attractive although lenders are reportedly turning more cautious which could lengthen transaction timelines.

Australia

Australia's economy heads into 2019 with 27 straight years of growth under its belt but despite its winning streak, the prospects for the coming year are more muted. Above-trend global growth and the supportive commodity cycle bolstered business sentiments in recent years, while the housing market generated significant wealth effects which sustained domestic spending.

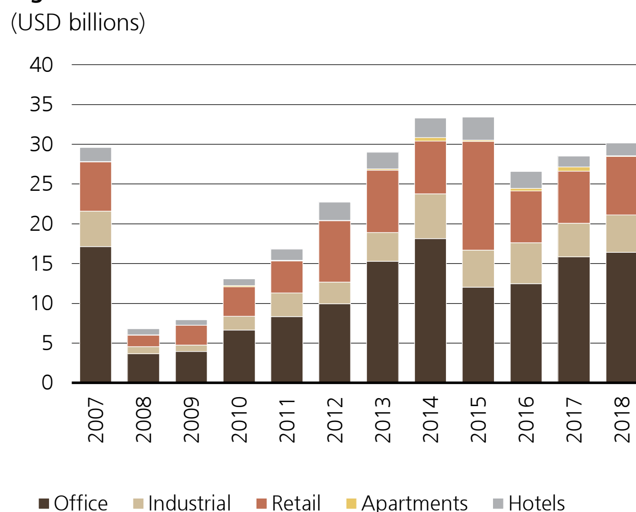
Clearly, near term downside risks are accumulating in the Australian economy, and the biggest headwinds stem from domestic factors; elevated levels of household debt and sluggish wage growth will limit consumer spending, while tightening of mortgage underwriting standards is having a double whammy effect on both the housing market and the banking sector. What could end up being a shot in the arm for households is the upcoming Federal election, due to be held by May 2019, given an expected cut in personal income tax ahead of the vote. Other factors that will remain supportive of the economy include government spending and business investment. And while the external environment is beset with uncertainty, export growth has been strong, in part due to a slight pick-up in commodity prices. In terms of monetary policy, interest rate hikes are unlikely in this cycle with the concerns about the lethargic wage growth and anaemic price inflation in Australia. The Reserve Bank of Australia (RBA) is likely to be wary of increasing the cost of debt at a time when the level of household debt is at a near term high.

Vacancy rates are at 10-year lows of 4.6% and 3.6% for the Sydney and Melbourne CBD markets respectively. Net face rents in the Sydney and Melbourne office rental market have been expanding since 2010/11, and the cycle looks set to extend in the coming year. Crucially, growth in white collar employment was robust, which reflects strong growth in the services sector and business expansion and points to continued demand for office space. Leasing interest in both markets is healthy but rents were also supported by stock withdrawals and low levels of completions which resulted in a dearth of options for tenants. Prime net effective rents are expected to continue rising in 2019, albeit at a much more moderate pace than before. Brisbane and Perth are lagging in the rental expansion cycle, with rental growth expected to escalate in 2019. Investors who are planning to put money to work in those cities should be cognizant that vacancy rates there are still elevated at double-digit rates and leasing risks are more significant than in the core markets of Sydney and Melbourne.

Retail trade in Australia has seen some improvement in 2018 amidst strong employment gains, although muted wage growth has capped the extent of the pick-up. Retail sales grew an average of 3.1% YoY per month in 11M18, up from the 2.4% average monthly growth seen in 2017. Despite the uplift in retail sales, structural challenges still pose headwinds for retail property. Store closures and consolidations continue to take place across Australia, with discount department stores particularly hard-hit; this has the greatest impact on sub-regional shopping centers compared to regional shopping centers and neighborhood centers which are supported by population growth and have a more defensive profile. CBD prime retail centers will be slightly more insulated from the challenges given the additional demand driver of rising inbound tourism – this has in turn attracted the attention of luxury retailers, particularly to Sydney CBD.

The heavy public spending into transportation projects across the nation, which has been part of the reason for the aforementioned stock withdrawals, have been supportive of industrial property. Construction firms have been increasingly seeking space due to the firm infrastructure pipeline and rise in building approvals. Sydney has already seen a prolonged period of rental growth but further upside is still expected in the coming quarters amidst strong demand and relatively weak supply growth. On the other hand, Melbourne's rental cycle started several years later than Sydney, with the corollary being that prime rents are expected to grow at a marginally stronger pace. The market dynamics have led to a growing trend of speculative developments, which is reportedly achieving strong leasing results prior to completion. Nevertheless, investors should be alert to potential risks arising from such a trend and remain selective on assets.

Figure 4: Australia real estate investment volumes
(USD billions)



Sources: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

There was an increase in cross border capital in Australia in 2018, although this was in large part due to Canadian group Oxford Properties' close to USD 5bn purchase of the Investa Office Fund, giving it access to a portfolio of 19 office assets down under (see Figure 4). Singaporean groups are also heavily invested, making it the second largest class of cross-border investors in Australia. Underlying investor interest in Australian office assets is strong given the (still) long runway for rent performance and relatively higher yields. Although there are signs of some increased investment volumes in Brisbane and Perth amid a hunt for yield and counter-cyclical plays, Sydney and Melbourne still dominated total capital flows, accounting for around 68% of total transaction volumes in Australia. Nevertheless, tighter lending conditions amid a push by the Reserve Bank of Australia to get banks to deleverage could weigh on transaction volumes in 2019.

China

Much has already been made about a slowdown in the world's second largest economy and the latest 2018 GDP numbers confirm the reality of a cooling China where GDP growth came in at 6.6%. In the just concluded National Party Congress, China once again moderated its GDP growth target downwards, aiming for a range of 6% to 6.5%, as opposed to a hard target of 6.5% in the previous year.

The onslaught of bad news may have created an air of pessimism but it is important to realize that firstly, part of the moderation is intentional and secondly, the government has room to ease policy. The government has been weaning the economy off of credit-driven expansion in order to lay the groundwork of more sustainable, consumption-driven growth. Relatively robust levels of consumption expenditure indicate that consumer spending is holding up and could be supported by spending on services. Nevertheless, in the face of external headwinds, Chinese policymakers have dialed back on its deleveraging stance and allowed monetary conditions to be slightly more relaxed. Various measures introduced since early 2018 will likely take effect and provide some buffer for 2019, with infrastructure investment and credit growth expected to reverse trend.

Overall office vacancy rates in Tier 1 cities ticked up in 4Q18 as evidence of a slowing economy and weaker sentiment from the trade conflict started to weigh on net absorption. Furthermore, leasing demand from the financial sector was also negatively impacted by earlier financial deleveraging and the clampdown on shadow banking.

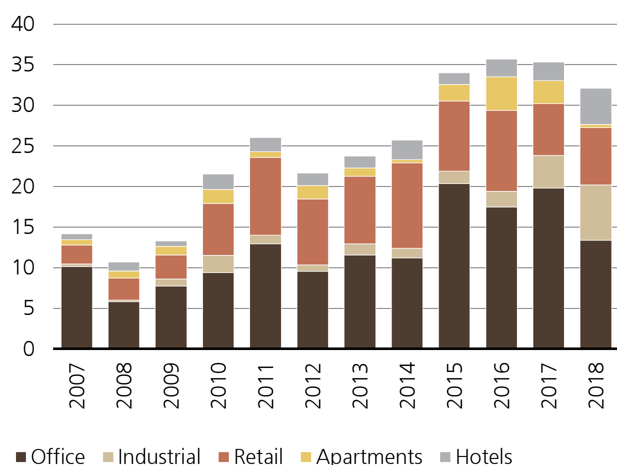
Net absorption fell around 20% and 30% YoY in Shanghai and Beijing respectively in 2018, and rental performance disappointed, particularly for Shanghai which posted a 1.2% YoY correction for the year. With significant pipeline supply on the horizon, the outlook remains subdued. Tier 2 cities are likely to take a bigger hit with vacancy rates expected to inch up towards 30% in 2019. Tier 1 cities are also expected to see rental corrections, with the exception being Guangzhou given that it faces relatively lower supply pressure. Despite the near term supply challenges, we are of the view that the country's transition towards a services-driven economy and the continued opening up of its financial sector will still bode well for the long term prospects of China's office market.

Similarly for the retail sector, the moderation in retail sales growth only paints part of the picture. China's economic development has resulted in an almost a tripling of urban disposable income per capita between 2007 and 2017, with wealth levels set to grow further as the economy continues to develop. This, together with growing urbanization, will provide fundamental support for the retail sector in the long term. In the near term, however, challenges facing the sector remain. Luxury retailers are still in consolidation mode, with fast fashion appearing to be approaching saturation in Tier 1 cities. In addition, department stores are trying to upgrade and reinvent themselves. In this challenging environment, what may be a fillip to the retail property market is government stimulus, namely reductions to the individual income tax as well as stimulus packages intended to boost consumption growth in 2019. This could provide some support for retail demand, but in the face of substantial pipeline supply, growth of prime retail rents in Tier 1 cities is likely to be capped in 2019.

The logistics sector is the outlier in China's commercial real estate space in 2018 where the average vacancy rate in 16 major cities declined to 9.0% from 12.6% in 2017.This has been a result of healthy demand and a lack of new supply. Even so, most of the vacant spaces are in Tier 2 cities; Tier 1 cities generally had lower levels of vacant stock and space is particularly tight in Beijing, which had a vacancy rate of 0.7%. While speculative developments have surged in the logistics segment in some cities, limited new supply in the high quality segment and obsolescence of existing logistics facilities have led to an overall shortfall in modern logistics stock per capita. Furthermore, the government's drive to improve the effectiveness of land by changing the use of land has also led to a reduction in industrial land supply. Coupled with structural demand drivers including the growth of e-commerce, the outlook for the logistics sector is generally positive, although a more nuanced location selection is still necessary in order to avoid cities with large amounts of new supply.

There was a slight softening of total transactions in China in 2018 as investment volumes into commercial real estate slipped 9.2% YoY (see Figure 5). Altogether, Tier 1 cities accounted for two-thirds of investment volumes in 2018, a reduction from roughly 85% in 2009 and reflecting investors' growing familiarity of other markets and increasing confidence in venturing out of the more familiar locations. With the funding environment now more favorable towards investors given the recent monetary easing measures and capital restricted from flowing out of the Mainland, domestic institutional capital will have a greater impetus to remain active onshore, which could lend support to real estate transactions in 2019.

Figure 5: China real estate investment volumes
(USD billions)



Sources: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Hong Kong

Hong Kong's economy managed a respectable 3.0% YoY growth in 2018, a shade lower than the six-year high expansion of 3.8% YoY recorded in 2017. Growth was largely supported by a strong 1H18 amid a sharp rebound in retail sales, a pick-up in tourist arrivals as well as front-loaded trading activity. The situation, however, turned especially toward the last quarter of the year when the impact of the trade war became more apparent.

Headwinds are expected on both the external and domestic fronts. The downside risks from the external environment are self-explanatory given that China and the US are Hong Kong's two biggest export partners. Both countries combined account for almost two-thirds of Hong Kong's total exports in 2018. Any trade friction between the two economic behemoths will invariably weigh on Hong Kong given its heavy reliance on trade. On the domestic front, the consumer will likely be weighed down by a host of factors, including stock market volatility, rising interest rates and early signs of some correction in housing prices after a multi-year run. What could lend some support to domestic consumption is tightness in the labor market and expected growth in inbound tourism enabled by the opening of the Hong Kong-Zhuhai-Macau bridge. Furthermore, policymakers have penciled in relief measures into the 2019/20 budget, such as a reduction in the salaries tax, but these measures are unlikely to change the trajectory of what is set to be an overall slower 2019.

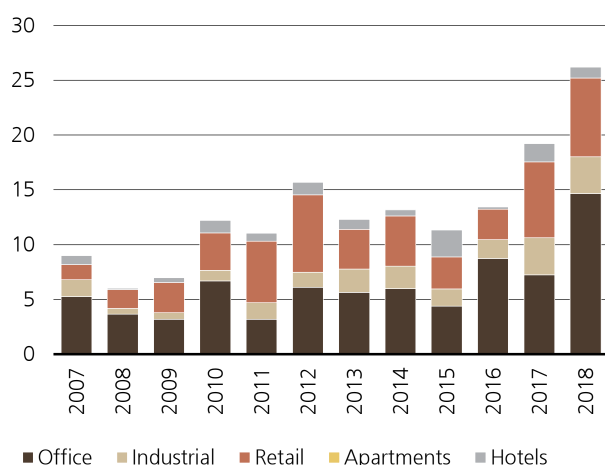
Net absorption in the overall Hong Kong office market reached an eight-year high of 3 million sq ft in 2018. Leasing activity in 4Q18 turned sluggish amidst external uncertainties such as capital controls on the Mainland and a weaker Chinese currency, which affected occupier demand from Chinese companies. That is likely to remain a factor in corporate real estate decisions this year given that there are no signs of capital controls letting up. Trade conflict and economic uncertainty are also likely to dampen sentiment among occupiers. What does work in the office market's favor is the low vacancy rate – rents in Central and overall Hong Kong Island hit record highs in 2018 as vacancy rates continued to compress to all-time lows, supporting rents. Even in the decentralized market of Kowloon, vacancy rates have trended downwards despite high supply volumes.

Indeed, the theme of decentralization continues to play out 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 at 0.9% in Central, that theme will only continue to gather pace in 2019, regardless of the expected weakening of occupier demand.

Optimism around retail real estate first started to grow in early 2018 when average high street rents inched up 0.3% QoQ in 1Q18 after 13 consecutive quarters of decline. That appears to be short-lived with rents contracting 0.4% QoQ most recently in 4Q18. The trend in rents mirrors that of retail sales, which saw a sharp rebound in early 2018, but in recent months have fallen prey to downbeat sentiment on the back of house price declines and stock market volatility. Tourist arrivals were strong and hit a record high of 65.1 million visitors in 2018, catapulted mostly by Mainland Chinese day-trippers. And while this lent support to discretionary spending, retail sales growth still slowed to 0.2% YoY in December. Leasing activity in 4Q18 came from healthcare and personal care retailers as well as cosmetics brands, but several leases were reportedly completed below market rents, demonstrating the challenges that still face the retail sector.

Prospects for the logistics market in Hong Kong appear to be the most robust of the commercial real estate space in spite of the trade war, although this is largely due to constraints on supply. According to CBRE, roughly 6 million sq ft of warehouse space could be removed from the 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 of 1.9% in 4Q18. While leasing demand could take a hit in 2019 from slowing trade activity, a lack of new warehouse supply will result in vacancy rates remaining low, which will likely support rental growth in 2019.

Figure 6: Hong Kong real estate investment volumes
(USD billions)



Sources: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Massive inflows into the office sector in 2018 single-handedly lifted investment volumes into Hong Kong's commercial real estate sector by about 40% YoY to a record USD 26bn (see Figure 6). Investment volumes into industrial real estate appeared to be flat, and retail property only saw a slight increase in transaction volumes and hotel transactions fell. Office transactions doubled to about USD 14.7bn in 2018, bolstered by several large deals such as the USD 6.8bn partial stake sale of The Center (less than a year after it grabbed headlines as the largest single office building transaction in history) and facilitated by the strong presence of Chinese and domestic capital. There was a discernible tapering off of investment flows in 2H18, and given already rich pricing and more muted sentiment, investment volumes in 2019 are expected to moderate from the record high levels in 2018.

Singapore

With a very open economy and major world economies among its top trading partners, Singapore can be described to be a bellwether of the global economy. GDP growth has been trending lower in 3Q18 and 4Q18, bringing full year 2018 growth to 3.2% YoY. Manufacturing appears to still be the main driver of the economy, supported by the semiconductor, biomedical and pharmaceutical and transport engineering sectors. Non-oil domestic exports (NODX) performed relatively well in 2018 with a 4.2% YoY expansion but it becomes clearer that the wind has been taken out of the NODX sails in more recent months with consecutive contractions seen in November and December.

The mantle is thus passed to the services sector to pick up the slack. Much of the pick-up in the services sector output has been driven by finance and insurance, information and communication and business services, with growth in the wholesale and retail trade, and transportation and storage services still fairly sluggish. While the labor market is tight, domestic consumption is unlikely to rise markedly due to rising interest rates and weakness in the housing market as a result of government cooling measures. GDP growth is likely to fall back to trend growth of around 2-3% YoY in 2019.

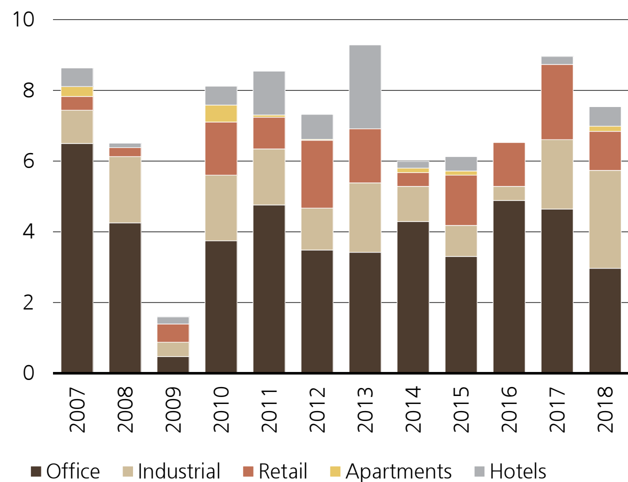
The office market in Singapore is in relatively early stages of a recovery which started in mid-2017. As at 3Q18, core CBD rents have been rising for five consecutive quarters by a total of 17% and further growth is expected in the coming years. Demand has been healthy in 2017 and 2018 amidst strong economic performance. This is thanks to the co-working boom which has taken root globally, but in a heartening sign, there is also evidence of demand broadening out to other sectors. This is evident in leasing activity which is reportedly coming from the banks, oil and gas firms, insurance companies and shipping firms. Expectations of buoyancy in demand for the coming year should be tempered given its close correlation with GDP growth; notwithstanding, the rental upcycle is expected to continue due to a lack of completions. Pipeline supply between 2019 and 2021 is expected to be roughly 0.7 million sq ft per year, less than half of both the 10-year average new supply of 1.8 million sq ft per year and the 10-year average net absorption of roughly 1.4 million sq ft per year. Granted, net absorption going forward is expected to be lower than historical levels given Singapore's maturing economy but even so, pipeline supply from 2019 to 2021 would still be considered relatively low. The next spike in completions is due in 2022 when close to 2 million sq ft of space is projected to enter the market; until then, the lack of options for occupiers is likely to result in continued rental gains in spite of a slower economy.

The worse seems to be over for the retail market given that average rents across all sub-markets have come off the bottom seen in 2Q17, according to CBRE data. However, this does not yet signify that the retail sector is out of the woods given that the increase in rents is marginal (ranging from 0.5-1.4% YoY as at 2Q18). The exception is the city fringe market where rents have not budged since bottoming in 2Q17. Three new malls totaling 1.25 million sq ft are expected to be completed in 2019, representing roughly 2% of total stock but this is unlikely to represent major supply pressure given that pre-commitment rates are high at 70-90%. Supply growth will taper off significantly post-2019, which removes completions as a downside risk. Notwithstanding, structural challenges facing demand remain formidable. Retailers face labor shortage and high operating costs, and are thus more likely to concentrate their efforts on selected well-performing stores than to be in a hurry to expand. Demand for space is increasingly coming from activity-based or experiential tenants, and these retailers tend to be more rent-sensitive. Some malls, particularly those in the city area, have even turned to co-working operators to fill up vacant space, and while this represents a new source of take-up, the trend is emblematic of a generally downbeat retail market. Nevertheless, malls still cater to a fundamental need, and asset selection is key to outperformance.

Signs of stabilization are also starting to emerge in the industrial sector and are likely to firm over the rest of 2019 as supply tapers off following a four-year influx. However, variations among the sub-sectors exist with business parks as the clear standout. Rents have generally been on a mild upward trend since early 2017, barring a marginal QoQ fluctuation in 3Q18. Not only have business parks been spared the onslaught of new completions that have plagued the other industrial sub-sectors, demand for business park space has generally been firm, particularly for newer buildings. This comes amid a push by the government to grow the high-tech and advanced manufacturing industries, which has broadly benefitted properties that cater to these high value-added sectors. With pipeline supply limited and demand likely to benefit from a widening rental gap with office space, business park rents are expected to maintain a positive upward momentum in the coming months.

Real estate investment volumes in Singapore slipped roughly 16% YoY in 2018 amid a fall in office transactions (see Figure 7). This is likely to be reflective of pricing levels and tight cap rates rather than a lack of interest, as Singapore still ranks high on investor surveys due to the ongoing cyclical recovery in the office market.

Figure 7: Singapore real estate investment volumes
(USD billions)



Sources: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Strategic viewpoint

In the last cycle, it was probably an easy call for real estate strategists to back the maxim *'stay hungry stay foolish'* given the rising tide. The ambitious investor could chew on more risk that he could realistically swallow and yet not have his bravado undermined, mainly because global real estate returns were largely supported by unprecedented low interest rates and the parallel rise of China as a global economic contender. At the very same time, changes in structural trends were unfolding quickly in a short span of time, providing avenues for capital to be deployed into logistics and alternative segments of real estate. All these led to a bonanza period for most property investors, of which the likelihood of looking foolish was probably the last thing on anyone's mind.

Asia has often been misperceived by many as an opportunistic play, ostensibly because much of the macro narrative is driven by emerging Asia. But the reality is that opportunities within APAC are polarized – investible real estate stock is largely confined to developed Asia which are facing lower (but stable) returns, much like the rest of the developed world, while in developing Asia most investments are very much development related.

Growing voice of prudence

As we continue to engage with investors and managers in the real estate space, the sense of exuberance has noticeably mellowed in the recent years, replaced in part by a growing and coherent voice of prudence. Let's be clear – the global economy is only beginning to soften, monetary policy normalization will be a gradual exercise, property markets around Asia are holding up fine, and capital continues to jostle for investments in the region. What has changed, really, is that new capital faces the diminishing ease of asset sourcing and transacting in key gateway cities. On top of that, generating returns that are commensurate with increased risks and financing constraints is proving to be a challenge, and even keeping up with the return profile of the previous investment vintage requires much more work and effort at this part of the cycle. Not dissimilar to the global scenario, economic growth in the APAC region is shifting into lower gear and more markets are experiencing late cycle dynamics.

Returns expectations have to be adjusted down

To that end, we observe investors increasingly leaning their convictions towards defensive and evergreen strategies. According to the 2019 Investment Intentions Survey published by ANREV, INREV and PREA, 54% of global investors intend to invest in core real estate, more than that for value-add and opportunistic plays. We think that this is a prudent approach which provides resilience and income stability in an increasingly uncertain environment. The drawback is that with entry pricing already tight, buying core assets now is unlikely to deliver the same kind of returns that have been had in past cycles, even after committing more operational resources into augmenting income returns. At the same time, it is inevitable that returns expectations have to be adjusted downwards, and that in itself would open up a whole world of realistic investment options for investors who are no longer chasing unattainable risk-adjusted returns. We are never hesitant in conveying this message to clients and investors, but there is a perpetual tug-of-war between ex-post returns and ex-ante expectations, especially when many investors have yet to be weaned off the sugar rush from the last cycle.

Given the diversity of the APAC markets and without admission of the specific risk profile and goals of any investor, we acknowledge that there cannot be a one size fits all approach in our strategic guidance to clients. It could be straightforward advocating a core strategy to a pension fund, but it may well be a tall task convincing an opportunistic investor that the perch of the risk curve is not necessarily a lovely place to be at now.

Our preferred investment opportunities and themes

With that in mind, and not wanting to be overly prescriptive, we set out some potential investment themes that are appropriate for investors of varying profiles. Obviously, portfolio construction will likely entail a combination of strategies, but this is nonetheless a convenient starting point.

Office investment themes

We are advocates of the following structural investment themes:

– Developed APAC office markets provide resilience:
  APAC markets occupy five spots in the top 10 positions of the September 2018 Global Financial Centres Index, with Hong Kong, Singapore and Tokyo ranking third, fourth and fifth, respectively. With varied dynamics and as proven historically, gateway cities in the key APAC developed markets do not run parallel property cycles. The corollary of that is the greater scope for tactical rotation and switching of strategies and market timing, to capture the most upside from this diversity of property cycles. Core investors should continue to pay attention to this segment, and be ready to target mis-priced and/or mis-managed assets.

– Growth centers arising from decentralization and infrastructure developments:
  We observe that the CBDs of Sydney and Melbourne are expanding with metro lines being built, and the urban rejuvenation projects taking place in Singapore and Hong Kong, are creating 'second CBDs' in these markets. In the case of Hong Kong and Sydney, limited supply of prime CBD office space has led to long term affordability concerns, and is already driving tenants towards Kowloon East and North Sydney, respectively. Arguably, these themes take a longer time to gain traction, and investors with a more patient investment horizon are better placed to undertake build-to-core strategies selectively.

– Buy-and-fix in aging but mature office markets:
  While a value-add strategy in itself seems to be somewhat tactical and hinges on market timing, it may not necessarily be true. If one looks at the age profile of well-located commercial assets in Shanghai, more than half of these assets were constructed at least twenty years ago when China was embarking on the opening up of its economy. As another case in point, we estimate that approximately 80% of small and midsized office buildings in Tokyo were built more than two decades ago.

Therein lies the long term opportunity to capitalize on the aging profile of office assets, and this theme could also be applicable in Hong Kong and Sydney. This strategy is not passive, and it is also not cyclical in nature. It does however require astute investors with a clear aptitude and capability in identifying such gaps, and executing on these 'buy-and-fix' opportunities in an evergreen approach.

Our top tactical opportunities include:

– Recovering markets which offer cyclical outperformance:
Some office sector laggards are already experiencing their time in the sun. In the Singapore office market, we have seen turnaround in rents and healthy absorption of prime CBDs office. The next supply up-cycle will only pick up in 2022, and the lack of options for occupiers is likely to result in continued rental gains in the near term. In Brisbane, there is real optimism that the resource-led economic gloom is seeing some light at the end of the tunnel. Investor interest has already been hyped up despite the still-elevated vacancy rates, but that is also on the back of projected recovery in the occupier market. New supply is expected to be limited in the next few years, alongside solid demand from tourism, education and healthcare sectors, which will provide a visible near term boost to the Brisbane office market.

– Value-add play in the Tokyo class B office space:
The upcoming supply avalanche is focused on the class A office segment, and newly built class B office buildings are relatively low in supply. With more than 90% of office tenants in Tokyo being small and medium companies employing less than 30 employees, the demand-supply certainly favors the value-add of existing class B office assets. This is not a long-hold strategy, but one where suitably sourced assets can be repositioned for timely exits.

– Lease-up with flexible and co-working tenants:
In many parts of Asia, the rise of co-working operators has provided much respite to office landlords. We see the sharing economy as a long term structural trend, but we are sticking a tactical label on co-working related strategies given the still unproven operating model backstopped by venture capital money and cash burn. Estimates differ, but co-working accounted for approximately 20% of all office absorption in the last year. Australia, Hong Kong, China and Singapore are major co-working battlefields, and the growth of small and flexible office users have helped to promote the growth of flexible spaces. The opportunistic investor might do well to adopt a rent reversion strategy by identifying under-managed office assets with gaps in the incumbent lease structure which can be plugged by co-working operators.

Retail investment themes

The displacement of retail by electronic commerce is clearly an unfolding trend, but we believe the structural dynamics of the retail sector remains favorable in certain investment themes:

– Prime retail retains dominance
Demand for prime and CBD retail space has been steady in key cities and markets in Japan and Australia, supported by inbound tourists and expansion by international retailers. The emergence of the middle class in Asia, in particular China, has created a new retail driver in the form of tourist spending. High street rents in the prime areas of Tokyo remain in growth mode, as limited new supply of prime retail space provides the support for rental uplifts. The situation is similar in Sydney and Melbourne where low vacancy continues to underpin the resilience of prime retail. Notably, accessing prime retail stock can be a tricky endeavor, and only the long term core investor is likely to be willing to endure tight entry yields in return for strong and enduring income returns.

– Suburban retail in pole position:
Low vacancy is underpinning the defensive qualities of dominant shopping centers in Australia and suburban malls in Singapore, Hong Kong and China. The dense urban layout of most developed Asian cities means that retail offerings are mostly a stone's throw away from most residential areas. Save perhaps for suburban neighborhoods in Australian cities, one will almost never need to travel more than 15 minutes in Tokyo, Singapore or Hong Kong in order to dine at a proper restaurant or to, for instance, purchase a bottle of detergent. What this means is that the need for disruption on physical retail by e-commerce is less flagrant. Investors can focus on non-discretionary retail, such as suburban malls which are supported by wide residential catchments and strong growth in non-discretionary domestic spending. Execution-focused investors will be able to tap on pockets of opportunities in Singapore and Hong Kong in the value enhancement of poorly managed suburban malls, of which the intrinsic value was never truly unlocked.

At this part of the cycle, the recommended tactical plays in the retail sector are:

- Retail conversions into alternative uses:
  The absolute returns driven investor with a penchant for riskier strategies may be keen to duplicate the conversion plays already happening in some parts of Europe. Given the superb locations of some retail assets, landlords and owners are choosing to back off in the fight against e-commerce and are increasingly open towards the conversion of their retail assets into alternative uses such as last-mile logistics, or co-working spaces.The change of use is clearly a risk that needs to be compensated for, as is the value-add and development risks that comes with major conversions. Where asset availability is an issue, investors can choose to participate in these conversions and probably take some risk off the books of owners.

- Recovering and underpriced markets:
  Hong Kong is the key representative in this theme. The Hong Kong prime retail sector has seen positive re-rating in the last two years, as investors believe that the sector has already bottomed and Chinese tourists are flocking back. In terms of pricing, capital values for Hong Kong retail is down by at least 40% since the last peak, and that probably makes for an opportune window of entry. The tenant mix of prime retail high street has however evolved, from the luxury brands to mid-range brands, where such tenants can support retail absorption, but are unable to afford the same levels of rents as luxury tenants. While attractive, investors should take heed not to underwrite rental growth that is based on overly optimistic projections.

- Outlet retailing in China:
  There has been strong interest by capital seeking exposure to the niche retail sector of outlet malls, in particular the international designer brand segment, where the structural themes of rising middle class aspirations and brand consciousness continue to drive the pent up demand for such real estate. The current offerings scattered across China are often sub-par and that creates a gap where landlords or investors with strong retail tenant networks will be able to benefit from these structural trends.

Industrial investment themes

In the industrial sector, the mega trends of technology and e-commerce have been the factors propelling investor interest in the last few years. Logistics will see value in developed APAC as there is still significant headroom for growth. We like and believe in the following structural opportunity:

- Build-to-core industrial space:
  On account of rising online sales and increasing imports, and increasing demand for efficiency in both transportation and warehousing, demand for modern logistics space is set to remain healthy across the APAC region, especially single tenanted built-to-suit facilities. Large modern logistics facilities in key distribution hubs and smaller units in infill submarkets that are positioned to serve urban locations continue to see healthy demand from retailers and 3PL providers. In Singapore, the government's focus on the end-user implies that the development margins could be attractive for build-to-suit logistics assets with forward leasing commitments by strong tenants, either in the high quality factory space or the business park segment. While there is a wide swath of development already completed or underway in cities such as Singapore, Tokyo, Melbourne, and Shanghai, most of these facilities are speculative and are not built to purpose. As such, building to core can better cater for the specifications of new technology that is applied in the industrial sector.

The following tactical opportunities in the industrial sector are suitable for investors willing to stomach greater risks:

- High tech industrial space in China:
  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. There is thus 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. Tactical project selection and acquisition competence should focus on the most desirable strongholds in Pearl River Delta and Yangtze River Delta where there is an established presence of higher value-add industrial sectors.

- Cold storage logistics in APAC:
  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. Asia 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. While the food currently offered for sale online is mostly packaged or preserved food, fresh food options are fast becoming prevalent and this calls for significant cold storage and distribution capacity in Asia.

Alternative investment themes
Not all alternative segments are created equal. Within the alternative real estate space, there are compelling investment strategies. We list a few of them here:

- Multifamily sector in Japan:
  We believe the growth of a deeper and institutionalized multifamily sector in Japan will gather momentum. While Japan has been under increasing strain from an aging population, inorganic population growth is still very strong in the metropolitans of Tokyo, Osaka and regional cities such as Nagoya. The themes driving demand for multifamily is very pronounced in Japan, where internal migrants flock to key cities for employment, and choose to lease small apartments for the sake of affordability. To that end, the multifamily assets operated by residential REITs consistently report occupancy rates in excess of 95%. International investors are still not late in the cycle given that core capitalization rates for multifamily are still approximately 200 bps above that of commercial property. As more and more individual sellers put their assets on the market, there is scope for investors to acquire portfolios at reasonable entry prices, or even work with major construction firms to forward commit on multifamily assets under development. With the stable income streams, core investors will find the Japan multifamily sector a strong addition to their investment portfolios.

- Limited service hotels in key regional gateway cities:
  The Asian hotel boom has been trending in the last few years on the back of strong tourist flows arising from burgeoning middle class economies and greater connectivity across the region. Arguably, the initial over-enthusiasm that is riding on the promise of tourism growth has led to a skewed distribution of hotels and new construction in certain markets. The fact is, demand fundamentals have not really deteriorated, and have instead improved in recent years. We believe the best opportunities in the hotel sector at this part of the cycle can be found in value-add and development projects, mainly in the limited service hotel segment in key regional gateway cities. Our top picks are Japan and Australia.

Epilogue

In terms of the rental cycle, certain markets are still in the early- to mid-stages of their respective recoveries and these could present short term opportunities to boost returns. All that said, the search for higher returns will continue to see investors put money into opportunistic plays and niche asset classes, although these will also serve as a means to gain exposure to long term structural growth themes. In an environment where abundant capital is chasing limited investible stock, there could also be an increasing focus on looking for core assets in non-core locations which offer high yields or spreads, such as secondary cities or secondary locations within prime cities.

Our key message in 2019 for Asia Pacific real estate investors is similar to last year. This year remains a risk-on year that will test the nerves of real estate investors. We believe market risks cannot be skirted totally, but surely can be prepared for. In particular, investors should not let their guard down by underwriting excessive capital growth or taking on risks that cannot be properly compensated for. Further, investors should also place a greater emphasis on more granular submarket and asset selection this year. We advocate taking a balanced approach – maintaining a defensive stance while remaining tactical in seeking and building on longer term opportunities.

Investment opportunities and themes to look out for in 2019

	Office	Retail	Industrial	Others
Structural themes	**Resilience in core office markets** E.g. developed APAC	**Prime retail to retain dominance** E.g. developed APAC	**Build to core** E.g. Singapore, Tokyo, Sydney, Melbourne, Shanghai	**Multifamily** E.g. Japan, Australia, Hong Kong (selective)
	Growth centers arising from decentralization and infrastructure E.g. Sydney, Hong Kong, Singapore, Shanghai	**Suburban retail underpinned by defensive qualities** E.g. Japan, Singapore, Hong Kong	**Prime logistics with high specifications** E.g. developed APAC	
	Buy-and-fix in aging but mature markets E.g. Tokyo, Hong Kong, Sydney			
Tactical themes	**Recovering markets with cyclical outperformance** E.g. Singapore, Brisbane	**Retail conversion into alternative uses** E.g. selective	**High specifications industrial** E.g. China (Pearl River Delta and Yangtze River Delta)	**Limited service hotels** E.g. key regional gateway cities
	Value-add play in Tokyo class B office space E.g. Tokyo	**Recovering and/or underpriced markets** E.g. Hong Kong	**Cold storage logistics** E.g. selective APAC	
	Lease-up strategy with flexible and co-working tenants E.g. Singapore, Hong Kong, Australia, China	**Outlet retail** E.g. Selective cities in China		

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