

Real Estate Outlook

Asia Pacific – Edition 1, 2021



Stay circumspect.



Shaowei Toh
Head of Real Estate Research
& Strategy – Asia Pacific



APAC outlook

Still under **the weather**.



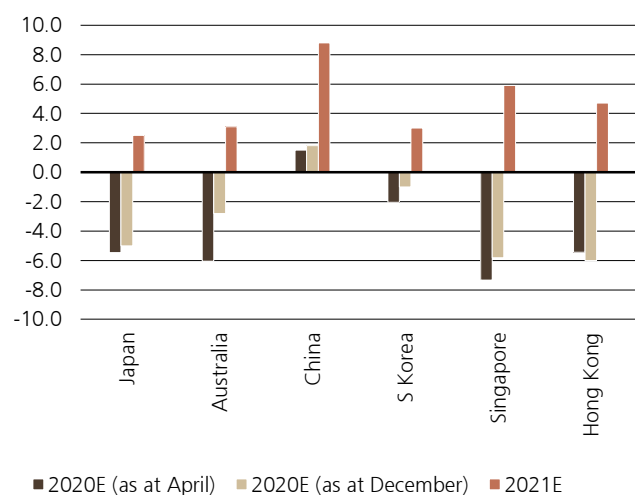
Most major APAC economies will bottom and reverse the growth decline by year-end. The general prognosis for 2021 is less negative but occupier performance will continue to face pressure. Real estate investors into APAC should not get carried away by expectations that the vaccine is a silver bullet and relax underwriting standards. Remain on the lookout for tactical opportunities arising from the pandemic.

Real estate fundamentals

The sun peeks through the clouds.

The encouraging news of the vaccine roll-out brought much optimism to Asia Pacific (APAC) markets towards the last few weeks of 2020. It could not have been timelier, as several economies such as Japan and South Korea are now grappling with a resurgence in COVID-19 cases that threatens to undo all the good work done in containing the virus. In other markets, there have been sporadic waves of community infections, but it can be argued that APAC governments are becoming adept at nipping the spread in the bud, preventing major clusters from forming. This level of diligence has been the hallmark of the APAC battle against the coronavirus, and it provides much needed confidence to investors who are watching very closely.

Figure 1: GDP growth by market (annual, real, %)



Source: Oxford Economics, January 2021

The fluid nature of the situation manifests itself in the growth prospects for various markets. In a way, forecasters have been revising the outlook for APAC economies regularly, taking into account high frequency data such as trade, investment and consumption figures. We have seen many iterations of GDP growth within APAC. In general, the adjustments have been mostly positive as markets display their resilience, supported by massive fiscal and monetary programs.

Amongst the major economies globally, China is looking to be the only one to record positive growth in 2020, followed by a strong rebound in the region of 8.8% in 2021 (see Figure 1). This is of much importance to the region, as a resurgent China will carry the APAC economy, particularly given the tight trade and supply chain linkages. Oxford Economics expects that most major APAC economies will bottom and reverse the decline by the end of 2021. The Purchasing Managers' Index (PMI) for Asia is a good leading indicator of business conditions and sentiments. We have seen a consistent recovery in the PMI since the trough in April 2020 when it was touching a low of 38. As at December 2020, Asia's PMI has reached a three-year high of 53.6. Part of that had to do with the restart of China's economy. However, it is too early to cheer. A concerted recovery in the US and Europe is needed to truly pull APAC out of the trenches.

Real estate investors should take heed not to get carried away by expectations that the vaccine is a silver bullet, and henceforth relax their underwriting standards. The underlying assumption is that inoculation programs are rolled out over the course of the next two years, and economic activity will normalize gradually. This process is bound to be uneven. In a downside scenario, bouts of fresh infections may lead to some markets having to undertake lockdown measures again. Most APAC governments have proven to be resolute in that regard, even if it brings about near-term economic pain. In short, the sun is hiding behind the clouds. We advise investors to stay circumspect while keeping an eye out for pockets of opportunities in key APAC markets.

Office

It is fair to say that APAC office markets are happy to put 2020 behind them, as the pandemic led to declines in rents across the Grade A segment. Data from CBRE suggests that net absorption in 2020 in the Grade A office segment was the lowest seen in the last 10 years across APAC, coming in at approximately 2.9 million sqm. Clearly, renewals and expansions were not forthcoming in 2020, as existing occupiers looked to reassess their office requirements while taking the pulse of the economic environment. That was a major drag on overall market rent performance (see Figure 2). The general prognosis for 2021 is less negative but key APAC markets will continue to face pressure on occupier performance, albeit in a less drastic manner.

Across the region, office completions in 2021 are expected to be on par with that in 2020. We saw some delays last year due to interruptions to work sites as well as the postponement of construction starts, and that helped to spread out the supply pipeline slightly. Some markets will feel the impact more than others. In Shanghai and Beijing, sustained construction activity suggests that CBD office vacancy rates will stay elevated and above 15% in the next few years. The bulk of the new supply will come through the competing decentralized areas.

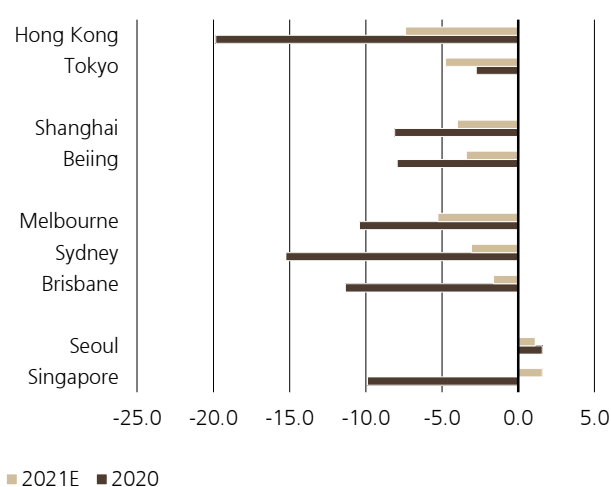
In Beijing, the diversion of demand has been acute, as we saw more than half of new leases in 2020 being committed in decentralized locations, partly also a flight to safety response due to lower occupancy costs. In Shanghai, more than three quarters of leasing activities took place in decentralized areas in 2020. To be sure, decentralized office locations are increasingly accessible, making them better substitutes nowadays, and this will continue to be a trend in the Chinese office markets.

In Sydney and Melbourne, the increased adoption of telecommuting has led to some firms putting their office space up for sub-lease. In these markets, vacancy rates are expected to rise to levels last seen in the Global Financial Crisis (GFC), at more than 8% conservatively. Tokyo and Seoul are two markets where the impetus for telecommuting has been somewhat muted. That helped to support office market occupancy throughout the pandemic. Together with Singapore, these markets will not see major supply in the next two years at least, which is supportive of rents.

Logistics

While high quality industrial space continues to be desired by tenants, especially those operating in the e-commerce area, elevated levels of supply have kept the lid on rent growth in the prior years before 2020. The immediate and sharp surge in demand due to the pandemic led to an outperformance in rent growth that will persist into 2021, albeit on a moderated basis. Data from PMA points to rent growth between 2% and 3% in 2021 for key prime logistics markets in APAC (see Figure 3).

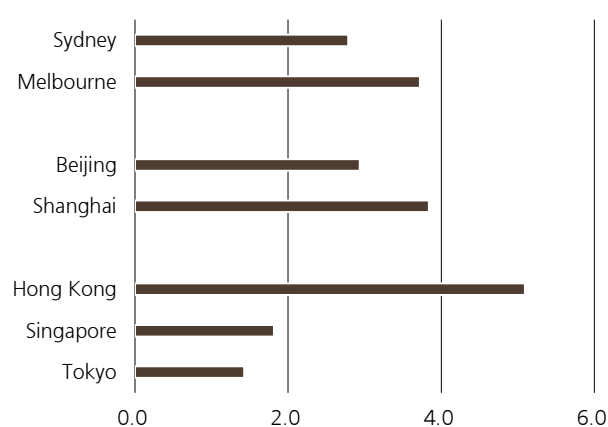
Figure 2: Grade A office rent growth (% , annual)



Source: CBRE, January 2021

Even as the macro outlook improves, we note that professional firms and financial institutions are starting to return some space and rationalize their office footprint. That will inadvertently add to secondary and shadow space. Will technology firms come to the rescue this time? In the last cycle, as recently as 2018, co-working firms picked up the slack from a softening office market. In this cycle, we have been seeing some relentless expansion by technology firms which have been relatively unscathed by the pandemic. That will offer some support, but will not plug the gap entirely.

Figure 3: Prime logistics rent growth 2021 (% , annual)



Source: PMA, November 2020

Prospects for China's logistics sector are underpinned by structural changes in the economy. Chief of this is the rise of the consumer class, partly driven by growing urbanization and rising income levels. The story has been playing out for many years and is expected to continue. China's logistics sector, however, is not just driven by domestic consumption and e-commerce. According to PMA, the retail sector accounts for 41% of China's logistics demand and third-party logistics (3PL) players make up 24%, while the manufacturing sector is also a major contributor with a 28% share. China's dominance as a global manufacturing center will thus be a key factor for the logistics sector. To that end, the government is pushing for an upgrade of the industrial sector through national strategies such as the Dual Circulation strategy.

In Sydney and Melbourne, demand from grocery operators and 3PLs spiked in 2020, but tenants highly dependent on international trade basically had little cashflow in the past few months as global ports and airports remained shut. That partly led to incentive levels reaching a decade high. On a blended basis, there is some weakness in the overall leasing market, as rent growth moderates in 2021. The winners and losers will be more defined, with high quality assets set to be more resilient during and after the pandemic.

Over at Greater Tokyo, despite the high volume of upcoming supply in the pipeline, oversupply risk is considerably lower than what it appears to be on paper. The pre-commitment rate for upcoming schemes stands at approximately 80%, with at least half the upcoming completions being fully pre-leased already. With continued investor interest focused on Tokyo logistics development, vacancies are set to steadily rise to around 5% by 2024. However, overall supply-demand dynamics should remain generally balanced.

Retail

In the retail sector, leasing demand in key APAC cities of Japan will remain focused on prime high streets, essential retail formats and locations that will see returning demand from tourists. In the near-term, the lack of inbound tourists and weak retailer sentiments will cancel out the relaxation of social restrictions as domestic consumers continue to tighten their purse strings. After falling by approximately 10% in 2020, we expect a decline in prime retail rents in the range of 2-5% in most APAC markets in 2021, with Hong Kong being a key outlier (5-10%). Markets such as Hong Kong and Singapore are reliant on inbound tourism because of their limited domestic consumer base, and they will continue to see weak retail performance.

The Spring Festival holidays in China will boost retail sales, but in a slightly different manner this year. As the pandemic rages on, the authorities are discouraging the annual travel rush in which typically more than 400 million people will make approximately 1.5 billion commuting trips in total, over this 40-day period. Stricter measures around domestic travel are being imposed by local governments and that will likely divert the retail spending back to key cities as many migrant workers remain in place.

In Japan, there have been casualties from the pandemic, as some major domestic retailers are downsizing or even ceasing operations. That said, many international retailers are still looking towards the Japan markets. Luxury brands such as Hublot, Chopard and Louis Vuitton, to name a few, have opened flagship stores in Osaka and Tokyo in the past few months. CBRE expects prime retail rents to drop by 4.3% over the next two years.

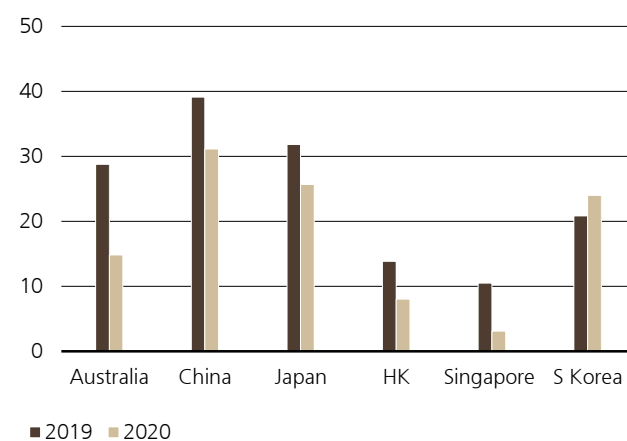
National retail sales have held up better than expected in Australia with a forecast full year decline of just -1.4% over 2020 as strong government and central bank support measures have largely sustained jobs and spending. However, spending has been very much directed towards essential items (food and pharmacy) and household goods, and away from discretionary items. On the supply side there is very little new space coming through, with a high possibility of delays, and some schemes being scrapped altogether. Over the longer-term, Australia's high population growth (once borders are re-opened) and low retail supply should support some rental recovery in Sydney and Melbourne, although we expect rents to stay below 2019 levels.

Capital markets

Pockets of rain.

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell by approximately 23% YoY in 2020 (see Figure 4). On a sectoral basis, it does not come as a surprise that retail and hotel transaction volumes plunged by around 41% YoY and 53% YoY, respectively.

Figure 4: Commercial real estate volumes (USD, billion)



Source: RCA, as at 29 January 2021

The uncertainty around the outlook for the retail and hotel sectors will not dissipate immediately even with the positive news on the global rollout of vaccination programs. There is capital sniffing around for distressed opportunities where the market dislocation might offer a good entry point.

We have not seen much distressed selling in 2020, as government support measures helped to buy some time for cash-strapped asset owners. The experience from the GFC tells us that the window for distressed sales typically happens in the next two years from the peak of the crisis. As governments start to taper down on support schemes, a fiscal cliff scenario looks increasingly probable, and that is likely going to separate the chaff from the wheat, leading to more distressed opportunities.

South Korea was the standout performer in the APAC region in 2020, as commercial real estate volumes jumped by 15% YoY, reaching a historical high of USD 24 billion. Both cross-border and domestic investors were active, with the latter's appetite for core office assets increasing due to limited opportunities offshore. CBD office cap rates compressed by almost 50bps in 2020, touching a low of 3.9%. Even so, 2021 is looking to be a strong extension of the previous year, with some transactions already undergoing due diligence. Investment volumes in both China and Japan contracted by 20% last year. Domestic buyers and end-users dominated the scene in Shanghai making up more than 80% of the transaction volumes.

Over in Beijing, local technology companies flexed their muscles, taking advantage of softer pricing to expand their office footprints. It is likely that 2021 will see a pivot towards domestic-led investments as the external geo-political environment continues to simmer. In Japan, we saw greater investment interest from cross-border capital, mainly due to how well Japan handled the pandemic in the first three quarters of 2020, coupled with an attractive yield spread across sectors such as office and multifamily. In contrast, a depressed stock market saw J-REIT activity subsiding but that is gradually reversing track.

The Hong Kong government abolished the double stamp duty on commercial property in late November 2020, effectively reducing stamp duties by almost half. That is likely to jumpstart the commercial property investment market. We expect the industrial sector to see the most action, as the Industrial Revitalization Scheme goes hand in hand with the cut in stamp duty.

Singapore saw the steepest drop in investment volumes in 2020, by almost 70% YoY. Let's not be misguided by that figure. The closure of borders had a disproportionate impact on investment activity, more so in a small market such as Singapore. In the latest joint report by the Urban Land Institute and PwC, Singapore was ranked first in APAC for investment prospects in 2021. What happened on the ground was a temporary shift from institutional activity in the commercial space towards high net worth individuals and family offices, focused on prime residential and shophouses. This is a true testament of Singapore's effective response in the fight against COVID-19.

Strategy viewpoint

The end of the rainbow.

Investors are searching for that pot of gold at the end of the rainbow, for when the pandemic is behind us. It feels simple enough for most investors who are piling into sectors where there is conviction around structural changes arising from the crisis. We have seen a surge in interest in data centers, last-mile logistics, and cold storage, amongst others. These are sectors that have emerged strong and are likely to endure. However, it is often a case of too little too late for recent entrants into these segments where returns have already been compromised to some extent. We believe there are also opportunities that are related to the pandemic but not direct plays, which could also lead to that elusive pot of gold.

Australia's multifamily sector: COVID-19 might have disrupted Australia's population growth story as net migration took a backseat. However, we strongly believe that the population growth momentum will resume. The pandemic has further exposed the weakness in the housing system where a chronic undersupply of housing threatens the socio-economic fabric, leading to a generation of renters in Australia. Various states have become more open to the idea of a private sector led multifamily initiative to solve the housing crisis, and that throws up tremendous opportunities for investors into this nascent sector.

Prime retail in Japan: A counter-cyclical play on prime retail in the key cities of Tokyo and Osaka may appear reckless today, but is likely to be astute. The underlying premise is that tourism has taken a beating but once the pandemic is brought under control, the situation will normalize. More prime retail assets are being re-priced in Japan as the current situation remains uncertain. At the right entry price, investors with longer holding periods may be able to undertake value-add work on retail assets and ride the structural rebound in tourist numbers.

Distressed acquisition in China: In August 2020, the People's Bank of China and the Ministry of Housing announced new financing regulations, assessing real estate developers against thresholds called the *three red lines*, which include the liability-asset ratio, net gearing, and cash to short-term debt metrics. The pressure on Chinese developers to ease up on leverage is intense and there is an urgent impetus to secure financing in a market ravaged by the pandemic. Many developers are now open to disposing of their non-core commercial property assets, and we believe it creates a tactical window for investors to gain access to a market that is traditionally tight on asset availability.

Our research team

Darnesha COLLIER
Kurt EDWARDS
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
Courtney LEE
Sean RYMELL
Shaowei TOH

For more information, please contact:

UBS Asset Management

Real Estate & Private Markets (REPM)
Research & Strategy

Shaowei Toh
+65-6495 3778
shaowei.toh@ubs.com



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