

Real Estate Outlook

Asia Pacific – Edition 2, 2020



May you live in interesting times.



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Uneven impact across Asia Pacific
property markets, for now.



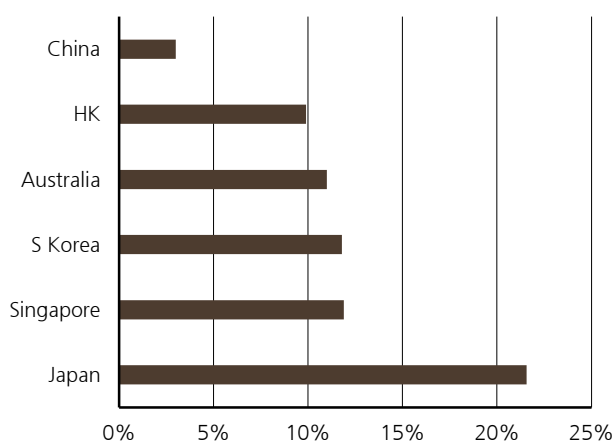
The epicenter of the pandemic has arguably shifted away from Asia Pacific. Monetary and fiscal responses to lend support to the real economy and keep labor markets calm. Limited scope for price discovery if the number of transactions dwindles in the near term. Some sectors will be more resilient than others, but eventually one cannot swim against the tide if the situation persists.

Real estate fundamentals – May you live in interesting times

Indeed, the satire in this proverb has never been more apparent than during this chaotic period. This expression is supposedly a translation of a derogatory Chinese curse (which has actually never been proven true but is assumed to be). And with the political debate raging over the origins of the COVID-19 virus, the irony is nonetheless thought provoking. That said, the macro backdrop continues to be uncertain owing to a lack of clarity over how long the outbreak may persist. Property markets and the underlying occupier performance are ultimately linked to economic fundamentals. Across the region, there have been ongoing downward adjustments to data such as jobs figures, growth numbers, manufacturing sentiments and more. Arguably, the epicenter of the pandemic has shifted away from Asia Pacific, but that in no way guarantees that a subsequent wave of contagion will not occur.

Most Asia Pacific central banks have loosened their monetary policies in the last three months, with the accommodative policies ranging among others from policy rate cuts, asset purchases, as well as reducing the required reserve ratios in some instances. These actions are committed to releasing liquidity to the real economy in the hope of staving off any credit-related events that might have undesired knock-on domino effects.

Figure 1: Fiscal support packages
(estimation, % of 2019 GDP)



Source: UBS Securities Ltd., Oxford Economics, CEIC, as at 23 April 2020

And more importantly, expansionary fiscal responses are now par for the course, which should hopefully provide much needed support towards businesses and keep labor markets calm. By our estimation, Japan, Singapore, Korea, Australia and Hong Kong are among the economies globally that have

pushed out stimulus packages valued in excess of 10% of GDP (see Figure 1). And this is probably just the beginning, as policymakers are keeping a close watch on economic data before doing more. Most of these government programs include cash handouts to households and concessions or rebates to businesses. In countries such as Singapore and Australia, legal guidance ensures that the concessions received by landlords are largely passed on to tenants, albeit with some conditions. At this stage, such actions are critical to stabilize the economy and lessen the pain of the private sector before the ongoing malaise extends into the financial and credit markets, and evolves into a full-fledged economic crisis. Also, these fiscal packages will ensure that private demand helps support the resumption of economic activities.

In conversations with market participants, we have been asked to pick the winners and losers in the post-pandemic Asia Pacific. There is no straightforward response, at least not until we have a better grasp of the longevity of this outbreak. In some countries in Asia we have seen better outcomes in the containment of COVID-19 within the community. China and South Korea offer valuable lessons in how government operating systems that are politically and culturally dissimilar can still achieve the same result of virus containment. In the case of South Korea, the approach of mass testing right at the initial stage of the virus outbreak, coupled with a solid healthcare system, all reaped dividends in the form of being able to resume economic activities as quickly and as normally as possible.

In China, relatively more draconian measures were enacted such as absolute lockdowns. The nationwide shutdown exerted a clear shock to the economy – recording a negative 6.8% YoY growth rate in the first quarter of 2020 – but that has also positioned China for a strong recovery going forward. At the time of writing the situation remains fluid, and this is likely to be a long-drawn battle which will see more ups and downs. The early success stories may not be enduring, as we saw in the case of Singapore, but that is not unexpected. It may be too early to pass judgement. The countries that displayed steadfast and effective governance will stamp their credentials as key investable markets long after this crisis is over.

All said, it is too early to expect any immediate economic recovery – at least not until we have confidence that a vaccine is developed for human use. Even if we wake up tomorrow in a world without COVID-19, it will take a while for momentum to pick up before the global engine starts to churn again. It is also overly opportunistic to be expecting bargain basement asset prices as not all property sectors have seen the same impact and downgrades. If any, this is an appropriate time for investors to take stock of their exposures, re-evaluate the resilience of existing portfolios, and start to position for opportunities once the dust begins to settle. On the macro front, we continue to watch for decay in key economic indicators such as unemployment rates and corporate insolvencies.

Retail

With COVID-19 only starting to break out across APAC in February or March, retail sales across APAC showed varied performance in 1Q20, although it is almost certain that the hit to domestic consumption will show up in late 1Q20 or early 2Q20. China saw retail sales plunge 20.5% YoY in the first two months of 2020, but that pales in comparison to Hong Kong, which saw the biggest fall among the major APAC economies with an average 35% YoY drop in retail sales in January and February as the region went from one crisis to another.

Early indications from China suggest a somewhat mixed picture of what happens post-lockdown. While some segments of the retail sector reported an uptick in activity, there are also signs of reluctance on the part of consumers to resume typical socializing and spending on discretionary consumption. Prime shopping center rents were flat in Shanghai and Beijing in 1Q20, but substantial pipeline supply in 2020 on top of already large volumes of completions in 2019 is likely to compound the woes of the retail sector. In Hong Kong, vacancy rates along Tier 1 streets in the core retail districts rose to a four-year high of 8.6% in 1Q20. Prime high street rents plunged 9.7% QoQ and 32.5% YoY in 1Q20 as the retail sector remains ravaged by a drying up of tourism and domestic spending.

The governments in Australia and Singapore have introduced measures to support retail tenants from the sudden fall in demand as a result of COVID-19 work stoppages and travel curbs. These initiatives include the co-funding of employee salaries, rent relief and a moratorium on the eviction of tenants. In Singapore, prime Orchard Road rents fell 0.2% YoY in 1Q20 and suburban rents were unchanged, although the full impact of COVID-19 will only be reflected in the coming quarters. In Japan, retail sales had already been affected by the consumption tax hike in 4Q19 before COVID-19 hit. And depending on how quickly tourism and domestic consumption regain ground, a near-term impact on retail occupier performance is expected.

Industrial

The logistics sector faces two competing forces amid the COVID-19 outbreak. With many places in lockdown, demand from ecommerce firms, third party logistics (3PL) players, food and pharmaceutical retailers has risen as more people take to on-line shopping. But with global trade already curtailed due to the US-China trade war and now doubly hit by the COVID-19 disruptions, overall occupier demand is likely to see a reduction as wide segments of the industrial landscape remain negatively affected by these developments. Nevertheless, even amid the downbeat mood, logistics is likely to emerge as one of the more resilient real estate sectors as it is less affected by the need for people to congregate, and the most ready to resume operations once lockdowns are lifted.

In Greater Tokyo, the overall vacancy rate for large, multi-tenant warehouses fell to its lowest ever recorded level of 0.5% despite the completion of seven new projects. Demand came from logistics and ecommerce companies, mirroring the trend seen elsewhere. Effective rents rose 2.1% QoQ, the largest quarterly increase since 1Q08, but we note that the performance could moderate going forward. Some of the net absorption stemmed from a surge in short-term leases to meet the increased demand for daily necessities, a trend which could be short lived. Tight vacancy rates in Sydney and Melbourne helped to support rents despite the rise in speculative developments, and prime rents rose 0.8% and 1.5% YoY in Melbourne and Sydney, respectively.

Most other markets in APAC recorded a more subdued picture. Overall demand was muted in China where there were observations of the postponement of some demand in 1Q20. Pipeline supply is expected to remain substantial in 2020 and place downward pressure on rents. The fall in trade volumes in Hong Kong has led to a reduction in leasing activity and a rise in the warehouse vacancy rate to 3.3%. Prime warehouse rents slipped 3.0% QoQ, reversing the two-year rental uptrend. In Singapore, the tech sector provided a boost to leasing activity for business parks, particularly for those in the city fringe and prime rents held steady in the quarter.

Office

At the time of writing, there has not been a complete set of data across the region to paint a full picture of how the office sector in APAC performed in 1Q20. According to CBRE, net absorption in the Tier 1 cities in China were mixed – while Shenzhen and Guangzhou managed to see net-positive office demand in 1Q20, Beijing and Shanghai contracted. Finance, tech and media companies contributed to leasing demand but there were also reports of some occupiers surrendering significant amounts of space. Prime rents contracted 0.1% QoQ in Shanghai and managed to stay flat in Beijing – but with substantial amounts of space expected to come on-stream over the rest of 2020, downward pressure on rents remains.

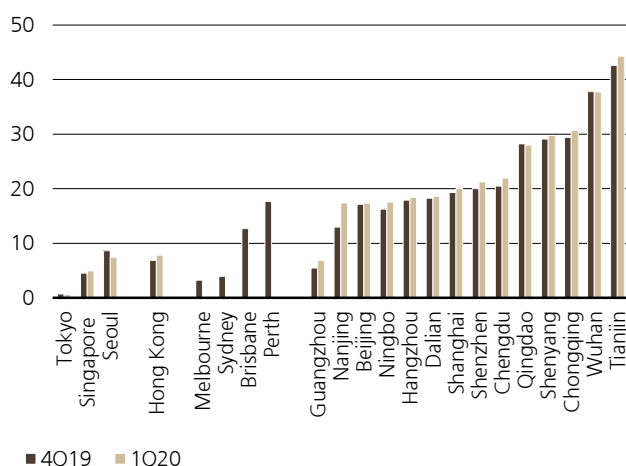
Hong Kong remains badly affected by the social unrest and COVID-19, which have severely dampened corporate sentiment towards real estate expansions. Net absorption contracted by close to 470,000 sqm, the worst reading since 2002 as some tenants, including several co-working operators, gave up space, leading to the Grade A vacancy rate shooting up to a 10-year high of 7.8% (see Figure 2). Prime rent fell 3.4% QoQ in 1Q20, with further corrections to be seen in the months ahead. Singapore managed to eke out positive net absorption on the back of demand from financial services and tech firms, but the looming economic downturn looks set to bring the rental upcycle to an end. Tokyo's prime office market is supported by a record low vacancy rate of 0.6%, while the large cash reserves of Japanese corporates is likely to provide a buffer for companies amid the uncertainty. Prime rents were flat in both markets in 1Q20 (see Figure 3).

In Australia, COVID-19 appears to be hastening the end of the multi-year rental upcycle in Sydney and Melbourne. JLL reports that both cities recorded negative net absorption, with Sydney worse hit as several occupiers moved out of the CBD. According to CBRE data, prime rents managed to hold

up, with marginal growth of 0.4% QoQ in Sydney, but this masks the true picture as landlords have also had to raise incentives in order to secure tenants. Rents in Melbourne were flat in the quarter, but the influx of new supply in 2020 will likely lead to correction in rents.

Figure 2: APAC CBD office vacancy rates

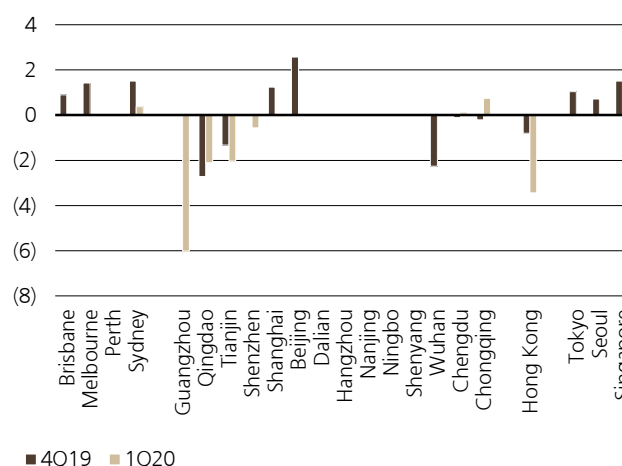
(% of existing stock)



Source: CBRE, 1Q20. Latest Australia data as at 4Q19

Figure 3: APAC CBD prime office rent growth

(%, QoQ)



Source: CBRE, 1Q20

Capital markets – A game of wait-and-see

Early evidence shows that the COVID-19 pandemic has had a detrimental effect on investment volumes – according to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property dropped by approximately 52% YoY in 1Q20, which is on par with or even larger than the declines seen in some quarters during the GFC (see Figure 4). Given the tangible nature of real estate and the need to conduct site inspections before concluding a deal, the decline is a natural consequence of social distancing measures and the global restrictions on overseas travel. As it stands, most of the deals inked in 1Q20 had been in discussion since 2019. Pricing expectations of both buyers and sellers are likely to become much more uncertain, with investors likely to delay decisions as they wait to see how capital values get affected by the subsequent economic fallout. There is limited scope for price discovery if the number of transactions dwindles in the next few months.

Unsurprisingly, Hong Kong took the largest hit in 1Q20 as transaction volumes of commercial real estate plunged 87% YoY to USD 624 million, its lowest reading in over 11 years. Investor confidence had been shaken by the social unrest in 2019, which has taken a toll on the retail and hospitality sectors. While office deals have long been the mainstay of transaction volumes in Hong Kong, those plummeted in the latest quarter amid a weakening of market fundamentals.

Instead, trades were mostly dominated by the sale of industrial properties, with investors drawn to the revitalization potential of the sector. Major deals included the acquisition of Hang Fat Industrial Building and Belle Tower, both for redevelopment purposes.

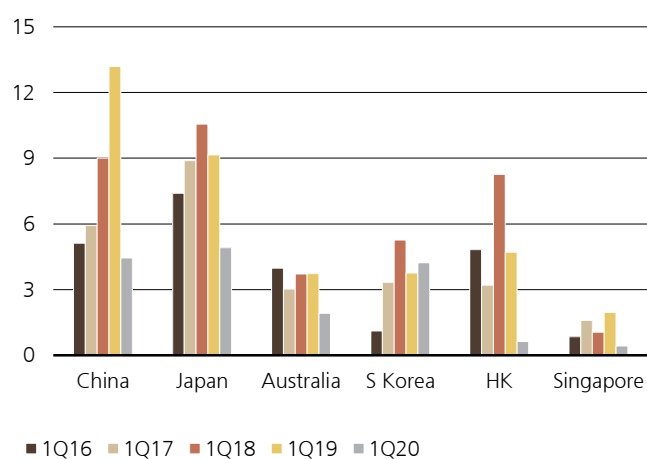
Singapore saw the next biggest drop of 79% YoY to USD 414 million in 1Q20, due in part to a scarcity of available assets. All of the office transactions in the quarter were that of strata units sold to high net worth individuals and family offices. Other notable deals involved the better-performing segments of the industrial market such as Galaxis, a city-fringe business park property, and Wisma Gulab, a high-specifications industrial building.

China experienced a 66% YoY drop in transaction volumes, to USD 4.4 billion. Many of the other deals involved office buildings in the gateway cities of Shanghai and Beijing. But with sentiment already weakened since 2H19, the outlook is undoubtedly dampened further by COVID-19, with RCA observing an increase in the proportion of distressed asset sales in February and March.

Japan and Australia both saw falls of around 46-49% YoY in transaction volumes in 1Q20. South Korea was the outlier in 1Q20, bucking the trend of steep declines with a 12.5% YoY increase in transaction volumes. Major transactions included a USD 418 million acquisition of Namsan Square and the USD 235 million sale of Samsung Life Yeouido Building (both in the Seoul office market).

While there have been no observations of widespread panic selling in the APAC real estate market this far, it is evidently still early days in the economic downturn that is being unleashed by COVID-19. And without a clear exit from the global lockdowns in sight, investment volumes are likely to stay muted for the rest of the year with real estate capital values inevitably taking a hit. Buying activity will likely shift towards domestic investors with interest expected to be centered around well-occupied, income-producing assets.

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



Source: RCA, as at 23 April 2020

Strategy viewpoint – Buying time

The direct impact of COVID-19 has hit the retail and hospitality sectors globally, and not just in Asia Pacific. Notwithstanding, one sector that has been less affected (for now) is the office market as the impact of COVID-19 is arguably less direct (although it will likely manifest itself should economic conditions deteriorate in a protracted scenario). That is not to imply that the office sector is insulated from the fallout. When we examined the tenant mix and take-up of office space in the key markets in Asia Pacific, two occupier segments raised red flags, namely co-working operators and manufacturing tenants.

Office sectors with deep linkages to manufacturing tenants, such as in Japan and South Korea, are immediately affected by the slowdown in regional and global demand. To a lesser extent, the office markets of China and Singapore are also exposed to tenants from the manufacturing segment.

With global consumer sentiments at record lows and a sharp drop in capital good investments, even APAC economies engaged in high-end manufacturing are looking at a plunge in industrial production in the near term. In office markets that have more than a quarter of absorption by corporates in the manufacturing sector, there is a real risk of insolvencies and delinquencies should we see COVID-19 persist. It is likely that expansion and renewal plans will be put on hold in the near future. As much as 2019 office occupier performance was solid, we will most likely see an increase in secondary space and a climb in vacancy rates in 2020.

We leave aside the perpetual debate over the fundamental strengths and weaknesses of the flexible office model amplified by the WeWork IPO debacle last year. The truth is that the co-working economy never anticipated the emergence of, or impact from, an invisible threat like a virus. With social distancing and lockdowns becoming a common thing, flexible office operators have to immediately contend with a sharp fall in usage and income. And that is why the immediate and direct impact of COVID-19 is being felt more in this segment. Landlords with an outsized exposure to co-working have enjoyed a good run, but are now faced with the prospects of covenants being breached or even termination of leases by this same group of tenants.

Over the last three years, office absorption by flexible office operators has increased steadily. In markets such as Hong Kong and Singapore, flexible office operators made up more than 20% of office space absorption, just behind the finance sector. We expect that if the virus is not contained soon enough and people are still staying home, smaller co-working operators will run into cash flow issues and we will likely see some office space being returned. In another related scenario, we may also see massive consolidation happening, although that would also result in a rationalization of co-working footprint. In the case of Singapore, while prime and grade A office supply has been limited, we already saw overall demand tapering off in 2019 due to ongoing external trade tensions. A similar comment can be made for the Hong Kong CBD, which was affected by the pullback in mainland Chinese office tenants, as well as weakening corporate sentiments in 2019. And clearly, the slowdown in co-working activity may also be seen in other markets such as Australia and China.

For now, our view is that most markets and sectors cannot swim against the tide given that overall global economic fundamentals have taken a beating. The retail and hospitality sectors will need to regroup after this pandemic. Industrial segments that focus on manufacturing and the old economy will face downward pressures. In the office sector, some markets will be more resilient than others, but again, a lot depends on how quickly we see a return to normality.

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