Real Estate Outlook

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Real estate yet to mirror real economy.

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Safeguarding lives and livelihoods key to regional property outlook.

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Governments in Asia have largely proven their resolve in protecting lives and livelihoods. The report card for Asia thus far is satisfactory and this bodes well in general for real estate. A slowdown in investment activity was expected and is uneven across markets but pricing stays calm. There is still fact finding being undertaken to gauge the post-pandemic impact on end user demand across sectors.

Real estate fundamentals – On lives and livelihoods

Asia Pacific offers timely lessons in re-opening
As the COVID-19 outbreak continues to spread across the globe, policymakers have to grapple with the dilemma of choosing between lives and livelihoods. It is a delicate balancing act; opening up economies prematurely will lead to more infections, but prolonged shutdowns may inflict economic scarring that could take many years to recover from.

The economist ponders the value of life. Morally speaking, every single life is priceless. However, many governments have frequently adopted a metric to guide cost-benefit trade-offs in policy matters such as traffic control or pollution containment. In 1968, Nobel laureate Thomas Schelling coined the term "value of statistical life" (VSL). In the simplest terms, a VSL is an estimate of how much a person is willing to pay to reduce his/her risk of death. As various sources will point to, the VSL is approximately AUD 4.2 million in Australia, while that same metric is almost USD 10 million in the United States. It is on this basis that some economists start to assess how much countries should theoretically be willing to pay in terms of the associated costs of social distancing and lockdowns vis-a-vis minimizing fatalities due to the coronavirus. Or rather, at which tipping point do we decide that it makes better financial sense in saving livelihoods (opening up) over lives (lockdowns)?

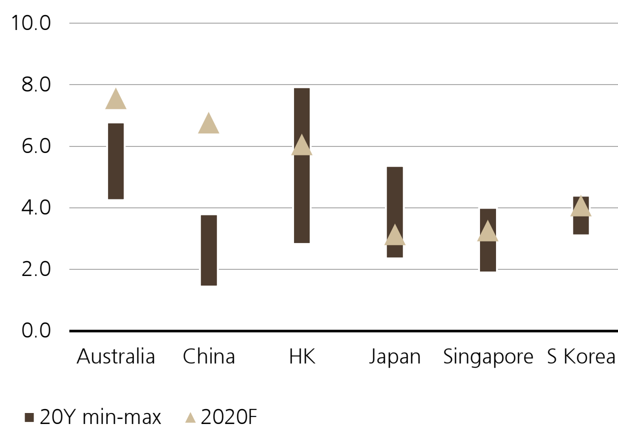
Obviously, this is an overly simplistic and academic endeavor. A life is not just a statistic. One life lost is one too many. Most Asia Pacific governments have adopted a trial and error approach towards the resumption of economic activities, while taking calculated risks in ensuring second or third waves of infections are under control. Instead of a draconian elimination tactic, an aggressive suppression strategy seems to the favored approach in Asia.

As the rest of the world hunkered down and initiated more severe forms of lockdowns, countries such as China, New Zealand, Japan, South Korea, and Australia were amongst the few to relax lockdown measures. The scenes of shoppers trawling the malls and sipping on cappuccinos at cafés offered glimpses of how successful suppression efforts can kick start economic re-opening. At the point of writing, we are seeing a resurgence in new infections in some countries, but that is to be expected.

Saving livelihoods and lives can be managed in tandem, not always perfectly, but arguably on a best effort basis. In our estimation, Japan, Singapore, Australia and Hong Kong are among the economies globally that have pushed out stimulus packages valued in excess of 10% of GDP.

Ensuring that cash handouts and concessions to households and corporates are timely and sufficient goes a long way towards supporting the resumption of economic activities. The downside risk is that subsequent waves of infections can and will occur from time to time. As we have seen in China, Korea and the Victoria state of Australia recently, the reactions by the authorities have been immediate, forceful and confident. This is probably how living in the new normal might look like before the world figures out a medical solution.

Figure 1: Unemployment rates (estimation, %)



Source: Oxford Economics, CEIC, as at 21 July 2020

Despite all that has been done, the truth is, jobs have been lost, workers are furloughed and incomes are affected. These effects are inevitable. However, we see Asia Pacific labor markets doing much better than was originally anticipated (see Figure 1). This is somewhat due to the non-financial nature of this crisis as yet, and also partly due to the balance sheet resilience of Asian corporates. In Australia, there were early estimations of a 10-13% unemployment rate in 2020, which is now being revised down to less than 8% by the Australian central bank. In addition, in Japan, Singapore and South Korea technical recessions are already being recorded, but the labor markets are likely to remain range-bound within the peaks and troughs of the last twenty years.

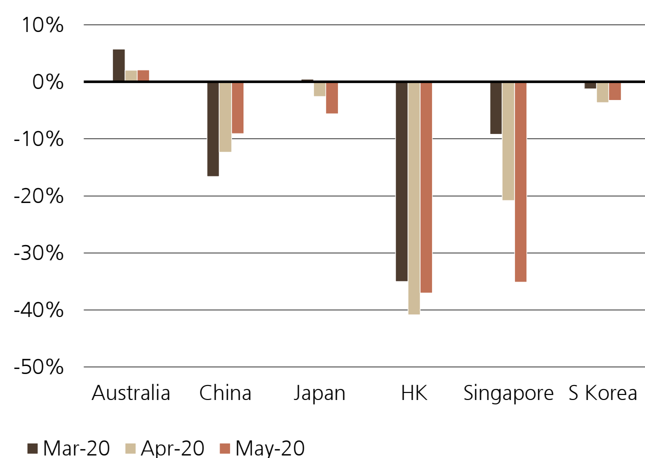
Saving lives now may come at a great expense to livelihoods but they are not mutually exclusive. Governments in Asia have proven their resolve in safeguarding livelihoods, which will reap dividends through the virtuous cycle of creating and supporting more livelihoods during the post-pandemic recovery phase. There will be hiccups along the way, but all in, the report card for Asia thus far can be said to be satisfactory and this bodes well in general for real estate markets in the region.

Retail

The market was expecting greater clarity in terms of the full impact of COVID-19 on the retail sector, following a rather uneven showing observed in the last quarter. Not surprisingly, retail sales performance (see Figure 2) was highly dependent on the extent and timing of the lockdowns.

On a three month moving average basis, Australia's retail sales growth was still in positive territory, boosted by a record surge in retail spending in the month of May alone. China saw improving retail sales performance, although that still pales in comparison with the same period in 2019. The brewing political and social tensions in Hong Kong were an overriding drag on consumer sentiment even as Hong Kong managed to flatten the COVID-19 curve without the need for a total lockdown. Singapore only gradually lifted its mobility restrictions in June, and the stress was clearly felt across the retail segment as retail sales fell by more than 35% in May alone.

Figure 2: Retail sales growth (3mma, %)



Source: CEIC, latest available as at May 2020

The retail sector is precariously standing on one leg, relying solely on domestic consumers as international travel looks to remain curtailed going forward. Domestic consumption can only go so far in supporting prime retail.

In Shanghai and Beijing, according to CBRE data, prime retail rents were flat in 2Q20, an extraordinary show of resilience. While things appear to be looking up for Australia, the dearth of inbound tourists and weak retailer sentiments were barely offset by the timely relaxation in social restrictions, which led to prime high street rents staying flat too. However, Sydney shopping centers saw a 5.1% YoY decline in rents. The same can be said for Singapore where retail rents fell by 1.5% this quarter. In Tokyo, high street retail rents were unchanged from the same period last year. Hong Kong prime retail rents fell by 36.1% YoY in 2Q20, alongside an almost 54% plunge in values. As most government support measures start to wind down from the third quarter, we can expect a bigger impact on the retail occupier markets at the end of this year.

Industrial

Extending from the last quarter, the dichotomy between sub-segments within the industrial sector is very clear. Even in most of Asia Pacific, where economic and industrial activities are stirring back to life, weak global demand is an overwhelming headwind for manufacturing and trade-reliant countries. The US and Europe are amongst the biggest export markets for Asian industrialists, and until the COVID-19 situation improves in other continents, industrial production and storage is likely to remain soft. This puts a dampener on overall rent growth in the industrial sector even as the e-commerce storyline hogs the limelight. To that end, we saw prime rents in Hong Kong and Singapore fall by approximately 3.0% YoY and 1.3% YoY, respectively, in 2Q20.

Outside of China, Asia Pacific countries have relatively low online penetration rates, and that means the growth headroom for logistics space is high in the region. The demand side of the logistics equation needs no elaboration by now. Prime logistics rents in Greater Tokyo, Shanghai, Beijing, Sydney and Melbourne all saw marginal YoY growth in this quarter. Instead, supply is an issue in some markets such as Singapore, Shanghai and the western parts of Sydney and Melbourne, even as we expect completion schedules to be pushed back. In these markets, we see some pressure on rents and occupancy beyond the second half of 2020. In Beijing and Tokyo, land for development is constrained in the infill areas, which is likely to be supportive of occupier performance, although outer-city supply is high.

Office

We are starting to see vacancies creeping up in the office sectors across most Asia Pacific markets. Despite governments offering concessions and throwing multiple lifelines at the corporate sector, it is certain that no one can swim against the tide. What we observe is not a widespread weakness in occupancy nor sharp rent declines but rather a pullback in leasing activity and increase in space surrenders in some markets.

To be sure, corporates started 2020 on a wary footing, with most companies in Asia having experienced significant volatility in earnings owing to the prolonged trade tensions between China and the US last year. Hence, many service sector and old economy tenants did not overextend themselves in terms of office space requirements, which also means less need to rationalize now. New economy occupiers, such as those in the technology and media sectors, continued to display appetite for office space. In China, the gap between the tier one and lower tier cities is widening, especially as lower tier cities were already grappling with the indigestion of office supply.

This is not to suggest that Shanghai and Beijing are faring much better, with both rent growth profiles deteriorating quickly in the face of significant planned completions. In Shanghai, the office vacancy rate came in at 19.9% in 2Q20, which is flat from the last quarter but almost two percentage points higher than in 2Q19. Beijing was not spared the

carnage, with overall office vacancy touching almost 16% in the same period, almost double from the 8.3% in 2Q19. Even though China started opening up and getting back on its feet much earlier than other countries in Asia, the side effects of the trade war and oversupply situation all acted together to hold back the office market performance. Also, China provides a glimpse of what is to come in other markets as the lagged effect of the global slowdown manifests itself in the office sectors in the region.

In Tokyo, the weakening economy has affected smaller companies more than the large corporates, with the latter still sitting on cash reserves which are likely to provide a buffer against massive corporate insolvencies and redundancies. The trade dispute and pandemic have effectively interrupted Singapore's two years of office market up-cycle, and we find it increasingly difficult to justify the demand story even though a low level of completions is supportive of market dynamics. The same can be said for Hong Kong, of which the current conundrum is further mired in geopolitical uncertainties.

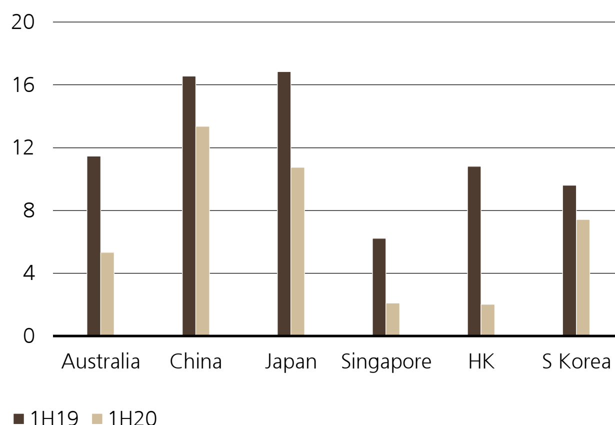
Capital markets – The calm within the storm

Pricing stays still while activity retreats

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell by approximately 42% YoY in 1H20. Across the key markets in the region, the slowdown in investment activity was uneven as some markets experienced sharper pullbacks than others (see Figure 3). But consistently, with the exception of Hong Kong, real estate pricing has stayed rather steady.

The slowdown in activity can be generally viewed as the natural consequence of safe distancing measures and global restrictions on overseas travel. Most of the deals inked in 1H20 had already been in discussions since 2019. But that cannot explain the entire situation, because both buyers and sellers are also likely to have delayed investment decisions as they wait to see how capital values are adjusted. The lack of clarity over the extent and longevity of the pandemic is a major consideration these days. As it stands, many Asia Pacific countries are not out of the woods, as second and even third waves of virus outbreaks already threaten to further impede investment momentum and price discovery.

Figure 3: Commercial real estate volumes (USD, billion)



Source: RCA (as at 28 July 2020)

On a relative basis, Hong Kong and Singapore saw the sharpest drop in transaction volumes in the first half of 2020, falling by approximately 81% and 66%, respectively, from the same period last year. The commonality between the two countries lies in their small and open economies, which have been impacted by the shock to global demand for goods and services. That is where the similarities end. In the case of Hong Kong, the economy opened up quite early after the initial taming of the virus outbreak, but socio-political concerns continued to cast a dark shadow over its longer-term prospects. And the recent resurgence in infections is another limiting factor as we saw 2Q20 prime office capital values fall by more than 20.9% from the same quarter in 2019.

Singapore struggled with a three month lockdown that was intended as a circuit breaker to stem the spread of the virus in the community and within its foreign labor pool. While restrictions were gradually relaxed in June, the commercial property market basically came to a standstill this quarter, even though office valuations increased by almost 3.6% YoY. Foreign investors with a working presence in the city-state are still looking at deals while we also saw a major player in the technology sector finalize the acquisition of an office building. Looking ahead, given the stability of the government and the effectiveness of the virus containment efforts, we are likely to see more overseas investors looking to allocate in Singapore.

Australia recorded a fall in investment volumes by close to 54% YoY in the first half of 2020, while Japan did less worse and came in at a decline of 36% YoY. Logistics continues to be the key sector, although it appears that most investors are looking at developer funding and platform capital infusion rather than the outright acquisition of assets. In Japan, the multifamily sector bolstered its reputation as a resilient asset class, and that has led to greater interest in the segment.

Separately, China saw the smallest fall in investment activity this quarter, and that is partly due to its economy restarting earlier than other countries. As was the case during the GFC, it is likely that domestic investors will take the lead in the transactions market. The recent announcement of a pilot REIT program will open up another avenue for the securitization of income producing assets in the mainland.

There is ample dry powder waiting at the sidelines. A low rate environment globally will further bolster the appeal of real assets, especially for long-term investors. This storm has not brought about a knee-jerk rerating in pricing in most APAC markets, at least not yet. This calm is much welcomed, as buyers retreat temporarily while keeping a close eye on the markets. In some sectors such as retail, valuations will and have been adjusted, but the value proposition has also largely diminished, which explains the capital market performance.

In other sectors, there is ongoing fact finding being undertaken, such as in the office sector where landlords and investors are still trying to get a handle on what the end user demand for office space will resemble. The way we consume real estate will change after COVID-19, but what is the magnitude and impact? For now, these are unanswered questions, and hopefully the calm will continue within the storm as investors sit out the pandemic.

Strategy viewpoint – On living

Rise and shine, make your bed

As investors scan the Asia Pacific region, seeking refuge from the global carnage brought about by COVID-19, it is obvious that the multifamily sector has displayed tremendous grit. To be fair, this sector is not a serendipitous by-product of the COVID-19 crisis. Prior to 2020, the Asia Pacific multifamily thesis was already on the radar of many institutional investors.

In Asia Pacific, the largest and most developed multifamily market is Japan, and Tokyo itself ranks highly amongst global cities with the largest numbers of multifamily renters. Over the last three years, there has been an explosion in institutional interest in this space that is traditionally held closely by domestic operators. Compelling structural drivers underpin the theme, as low home ownership and solid internal migration generate a high propensity to rent.

Also, market forces primarily drive occupier dynamics in Japan and unlike some US and European cities, rent control is not prevalent. The fragmented nature of the Japanese multifamily landscape lent itself to disruption as inbound capital proactively partnered with local operators to gain access to assets and portfolios.

In Japan, multifamily rent collections have been consistent so far and anecdotal indications do not point to a major repricing in the asset class yet. We can all agree that having a roof over your head is a necessity, pandemic or not. The Japanese government has unleashed significant fiscal support in the form of income protection and cash handouts, and these are key in ensuring that tenants do not fall behind in their rent payments. Also, Japan Inc. is flush with cash reserves and while we see some weakness in the jobs market going forward, the impact of which is likely to be smaller than in other economies. The most important factor, which is intangible, is that cultural norms in the society emphasize trust and honor, and these values make the multifamily landlord-tenant relationship very strong resulting, in a limited movement in occupancy.

As we look ahead, investors can start to future-proof their multifamily exposure by ensuring that their strategies move in tandem with overarching changes in work-life patterns after COVID-19. There has been a focus on the acquisition of assets that comprise small unit layouts and are within walking distance to train stations. If we believe that home-based work arrangements will pick up pace, investors should start to look at assets with larger units that are located in suburban areas as renters start to prioritize living space efficiency over commuting time. What this means is that the absolute rent quantum remains the same for tenants as they shift to new working habits. The pre-emptive investor engaged in a greenfield strategy has to start thinking about what the design of Japan multifamily units will look like in the distant future instead of blindly allocating new capital into the sector.

What is next then? As we cast our horizons around Asia, investors with a track record in the multifamily segment should increasingly enlarge their geographical coverage towards other emerging multifamily markets such as in Australia and China. Admittedly, the nuances are not the same in every market but early movers can expect to reap greater dividends in a structural asset class instead of jostling for elbow space in crowded Japan.

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