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Aberdeen Standard Investments

Asia Pacific Real Estate Market Outlook

Q3 2020

"The global contraction triggered by the Covid-19 crisis has been unprecedented, but we think the recovery has already begun."

Executive summary

- The global contraction triggered by the Covid-19 crisis has been unprecedented, but we think the recovery has already begun. The reverse 'J' scenario remains our economic base case – i.e. a deep recession with a drawn out recovery and permanent loss in output. That said, we now see the risks around our base case as being balanced (versus skewed to the downside previously).
- All investment styles for non-listed real estate in Asia-Pacific (APAC) registered negative returns during the first quarter of 2020. This represents the first time returns have been negative since the Global Financial Crisis (GFC). We expect total returns to remain under pressure in the near term. We forecast an average total return of just -0.3% per annum (p.a.) for the region over the next three years and expect greater divergence in performance among sectors. We expect outperformance in industrial properties and multifamily rental apartments in Tokyo to be balanced by underperformance in the retail sector. On a risk-adjusted basis, we believe the real estate market in Japan remains relatively attractive within APAC.
- Despite the unprecedented contraction in economic activity, pricing for core real estate has remained surprisingly firm. This is especially the case for office properties in Seoul and industrial properties, in general. For investors who are able to venture out slightly on the risk spectrum, we think a core-plus or a light value-added strategy may offer a better risk-reward proposition (there is a higher likelihood of securing softer entry prices for assets with more leasing risks), compared with a core strategy. That said, we do not rule out the possibility of more core opportunities surfacing over the next 12 months – particularly if new waves of infection were to force extreme lockdowns to be re-imposed, causing greater volatility in the economy and financial markets.
- We believe important differences between cities need to be considered when assessing the long-term impact of flexible working arrangements on offices. For instance, we think the adoption of flexible work arrangements could be slower in Japan and the impact on office demand may be more limited compared with other markets. As such, we think there could be opportunities for more discerning investors to pick up good-quality assets in these markets if investor sentiment for offices were to become overly bearish.

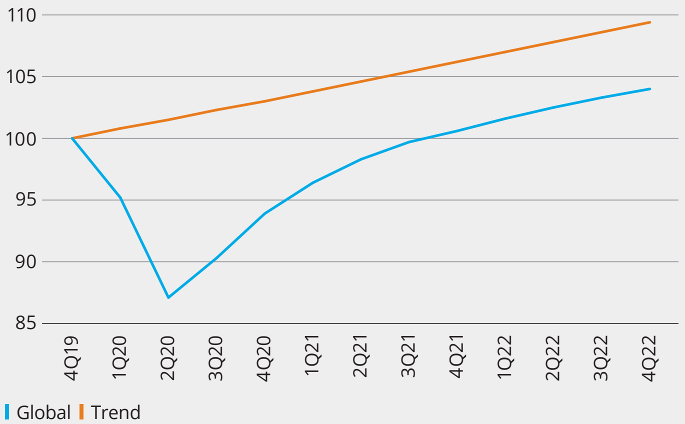
Economic outlook

- **Unprecedented shock; strong but partial rebound.** The global contraction triggered by the Covid-19 crisis has been unprecedented, but we think the recovery has already begun. Our colleagues at Aberdeen Standard Investments Research Institute (ASIRI) now expect a peak-to-trough global contraction of 13% over the first half of 2020, before a rapid but partial rebound in the second half of the year. Over the course of 2020 as a whole, we now forecast an average contraction of 7.4% (from -9.2% previously) for the global economy. This still leaves the global economy some way below where it was headed on its pre-crisis growth trend (Chart 1). We expect a 7.8% increase in global gross domestic product (GDP) next year (from +9.3% previously), before a moderation into 2022 (+4.1%, from +5.2% previously). Among the major economies in APAC, ASIRI has raised the 2020-21 GDP forecasts for Japan (+0.4 percentage points (%pt) and +0.1%pt, respectively), but kept the forecasts for India unchanged. In China, we raised the 2020 GDP forecast by 2.3%pt, but cut the 2021 and 2022 forecasts by 1.8%pt and 0.8%pt, respectively.
- **Risks around our base case are now balanced.** The reverse 'J' scenario remains the economic base case for our colleagues at ASIRI – i.e. a deep recession with a drawn-out recovery and permanent loss in output. That being said, we now see the risks around our base case as being balanced (versus skewed to the downside, previously). We had originally thought that a longer-lived economic shock with a ragged 'W'-shaped recovery, as second waves emerge and lockdowns are re-imposed, was a greater risk than a sharp 'U'-shaped recovery. We still think that a 'W'-shaped recovery is a key downside risk and we are concerned about virus hotspots in Latin America, and parts of the US and China. Our most recent judgement, however, is that better news on the research and production of an international vaccine have increased the probability of a mass vaccine being available earlier than the 12-18 months incorporated in our base case. Consequently, we have attached a higher probability to upside risks in our base case scenario.
- **China: industrial production back to pre-Covid level, but retail sales and real fixed asset investments (FAI) lag.** Industrial production in China climbed 1.5% month-on-month (m-m) in May – slower than the 2.2%m-m growth in April and lower than consensus forecast (+4.4% year-on-year (y-y), versus consensus +5% y-y). On the other hand, retail sales gained 5.4% m-m in May (from +11% m-m in April) and FAI increased 4%m-m during the month (from +7% m-m in April). The official data suggests industrial production has now largely caught up with its pre-coronavirus trend, but retail sales and FAI are still around 8% lower than what they were back in January. Importantly, the pace of recovery appears to have moderated. Liquidity conditions have loosened significantly since February. Total social financing gained 12.5% y-y to RMB3.2 trillion in May, which represents a slight acceleration from the 12% y-y pace in April. It also beat consensus expectations of RMB3.1 trillion. Credit growth has been strong for the past three months, but there have been reports that not all credit is going to support business activities.

While Beijing remains concerned about the risks building in China's financial system, risks of further Covid-19 outbreaks could still motivate further loosening of its monetary policy stance.

- **Japan: domestic resilience.** The fall in Japan's machinery orders accelerated to -12% m-m in April (from -0.4% m-m in March) but this was mostly led by external machinery orders (-21.6% m-m, from -1.3% m-m in March). In terms of the labour market, nominal cash wages fell by 0.6% y-y in April (from +0.1% y-y in March), with the drop in overtime payments being the biggest drag on income. The unemployment rate was hardly changed at 2.6% in April (versus 2.5% in March). Despite the crisis, ASIRI expects the labour market in Japan to remain relatively tight, with the unemployment rate likely to peak at just 3.4% by the middle of the year. Japan has beefed up the Employment Adjustment Subsidy Program it has been running since the 1970s, expanding eligibility and increasing the benefits paid to furloughed workers. This should help dampen the unemployment cycle. On the flipside, we think there is potential for wage deflation to return. It appears our view is underscored by the latest labour market data.
- **Australia: the hard work may have just begun.** It appears Australia is once again having a relatively good crisis, at least in terms of the impact of the virus itself, where local transmission has almost ended. The federal government and the central bank are also doing their part, with the former launching a historically large support program and the latter launching quantitative easing (QE). However, our colleagues at ASIRI believe that the hard work has only just begun, with the over-levered household sector likely to remain a drag on growth for many years to come.

Chart 1: Global GDP (level) forecast, indexed to 100 in the fourth quarter of 2019



Source: Aberdeen Standard Investments Research Institute; June 2020.

Real estate occupier trends

- **APAC offices: flexibility will be key focus in the longer term...** We believe the Covid-19 crisis has accelerated trends that were already underway prior to the pandemic. Flexibility is the key focus in terms of working arrangements and workspace solutions. In terms of flexible work arrangements, the last three months have demonstrated that there are many job functions that can be satisfactorily performed away from the office. Westpac, for instance, is reportedly reconsidering the need for thousands of technology staff to be in its major city offices. It has witnessed productivity increase among its developers and major projects have been delivered successfully by home-based teams during the lockdown in Australia. The troubles at WeWork have cast doubt over the business model of flexible workspace operators, especially since the health crisis is likely to reverse the trend of higher office density. Nonetheless, we think it is likely that more companies will work with flexible workspace operators over the longer term to cater for increasingly volatile spatial needs and to reduce their fixed office lease commitments.
- **...while the near-term outlook is mixed.** We forecast the average prime grade A office rent in APAC to decline 2.1% per annum (p.a.) over the next three years (from +1.8% p.a. in the last three years; Chart 2). Among the key APAC office markets, we are more positive about offices in Singapore and Tokyo, while most cautious in Hong Kong. We forecast prime grade A office rents in Singapore to rise 1.3% p.a. over the next three years (from +9.5% p.a. in the last three). The Singapore office market entered the crisis with fairly robust fundamentals, in our view. The prime grade A vacancy rate was 4.1% at the end of 2019 (versus an average of 6.5% in the past 10 years) and new supply scheduled for completion in 2020-22 represents just 8% of the end-2019 stock (versus an average of 9.3% in the past 10 years). Importantly, the bulk of the new completions in 2020 has been committed. We expect the withdrawal of stock for redevelopment under the central business district (CBD) incentive scheme and the potential relocation of some firms currently in Hong Kong to provide additional support for the market. A similar case can be made for the Tokyo office market. The prime grade A vacancy rate was just 0.6% at the end of 2019 and new supply in 2020-22 represents just 10.4% of end-2019 stock (with the bulk of the 2020 new supply already committed). We forecast prime Grade A office rents in Tokyo to be stable (+0.1% p.a.) over the next three years (from +3.5% p.a. in the past three).
- **APAC retail: structural challenges exacerbated by Covid-19.** Among the key property sectors, retail properties (along with hotels) have been the hardest hit by the Covid-19 crisis. Policy makers have reacted quickly with temporary measures aimed at helping retailers tide over the crisis. In Singapore, for instance, rent relief equivalent to four months of rent (evenly shared between the government and landlord) is given to small and medium retailers that have suffered a fall in revenue of at least 35% on account of the crisis. The temporary relief is unable to address the structural challenges faced by brick-and-mortar retail, though, many of which have been exacerbated by the crisis. According to PayPal Australia, customer sign-ups tripled pre-pandemic levels to almost a third of the Australian population during April. Importantly, the surge in new users in April included a 65% y-y jump in Australians aged 50 and above. Slower consumption, an accelerated loss of market share from

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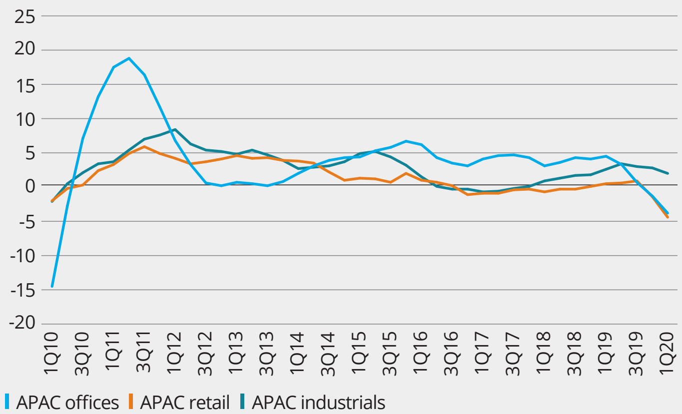
offline shopping to online, and thinning retailer margins continue to be the three key headwinds faced by retail properties. We forecast the average prime retail rent in APAC to fall by 6.3% p.a. over the next three years (from -1.1% p.a. in the past three years).

- **APAC industrial: long-term secular trends remain most favourable.** It appears the operational performance of industrial properties has held up relatively well during this crisis. For example, rent collection for industrial properties in Australia during the month of May was 75%, on average. This compares with 67% across all property sectors, based on data from Re-Leased. We expect the secular trends accelerated by the pandemic to underpin occupier demand over the longer term. These include an acceleration in migration from offline to online shopping, as well as potential changes in supply chain management (on-shoring and re-shoring of manufacturing capabilities, higher-than-usual inventories). While the long-term secular trends remain favourable for the sector, we expect some tenants to face solvency issues and for leasing demand to be more cautious in the near term. We forecast the average prime industrial rent in APAC to fall by 0.8% p.a. over the next three years (from +1.5% p.a. in the last three). Among the key markets in APAC, we are relatively positive on logistics properties in China's tier-one cities, as well as the primary Australian cities of Sydney and Melbourne. We are particularly interested in last-mile logistics in urban locations.
- **Tokyo multifamily rental apartments: tight labour market to remain a key support for demand.** Covid-19 has seemingly had a limited impact on the multifamily rental apartment market within the 23 wards of Tokyo. According to the latest data from Kantei, market rents for rental apartments in Tokyo's 23 wards gained an average of 5.6% y-y in April and May, despite the pandemic. This follows an average 6.4% y-y and a 4.3% y-y increase in the first quarters of 2020 and 2019, respectively. The market is concerned that potential labour market weakness in Japan could negatively impact demand for rental apartments in Tokyo. We expect market rental growth to slow, but we think investors should not be overly pessimistic. Our view is that the unemployment rate in Japan is likely to remain relatively low, potentially peaking at just 3.4% by the middle of the year. While wage deflation could return, we note that this has historically been a lesser driver of demand compared with the unemployment rate. For instance, market rents for rental apartments in Tokyo's 23 wards have climbed 1.9% p.a. over the past 10 years, while the overall vacancy rate has steadily declined from 7% to 2.2% over the same period. This coincided with a consistent fall in the unemployment rate to just 2.5% as of April (versus 5.1% 10 years ago). Nominal wages in Japan, on other hand, have remained largely static throughout this period (average +0.2% p.a.) with occasional wage deflation. We forecast the average market rent for Tokyo's rental apartments to gain 1.6% p.a. over the next three years (from +3.6% p.a. in the last three).

Chart 2: Net rental change (% y-y)



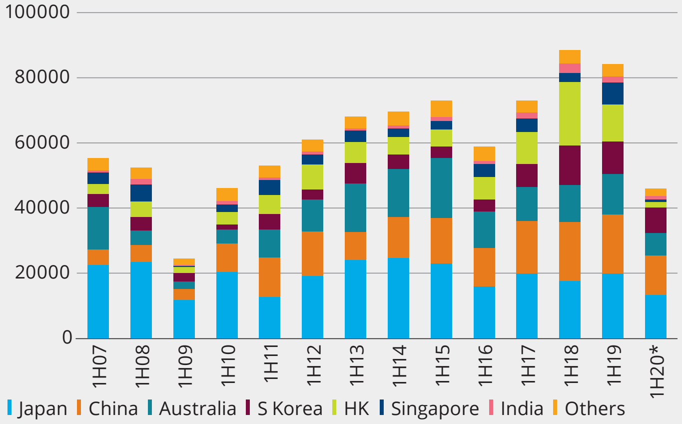
Source: Jones Lang LaSalle, Aberdeen Standard Investments, June 2020.

Investment trends

- **Transaction values: investment activity during the first half of 2020 is on track to fall by 45% y-y.** The latest data from Real Capital Analytics (RCA) suggests the total transaction value of investment properties in APAC (excluding development sites) is on track to register a 50% y-y decline in the second quarter of 2020, which would represent a bigger y-y fall compared with the 41.6% in the first quarter of 2020. This is not a surprise, in our view, considering mobility restrictions in many markets were significantly tightened only from late-March/early-April. This would take the total tally for the first six months in 2020 to about USD46 billion, or 45% lower than during the same period last year. This would also represent the lowest level of investment activity in APAC during the first half of a year since 2010 (but still significantly better than the market in the first half of 2009 during the GFC – Chart 3). In terms of geographical markets, South Korea was the best performer in the first half of 2020 (-20.4% y-y), while Singapore (-89.5% y-y) and Hong Kong (-85.5% y-y) were the worst. By sectors, residential properties were the most actively transacted in the first half of 2020 (-5.8% y-y), while retail properties had the biggest decline in activity (-62.8% y-y).
- **South Korea: record office prices achieved despite Covid-19.** Travel restrictions appear to have turned the focus of domestic capital in South Korea back home. Domestic institutional and private investors accounted for 62% (versus an average of 55% in the past 10 years) and 24% (versus an average of 18% in the past 10 years) of acquisitions, respectively, during the first half of 2020. Consequently, record prices have been set, especially in the office market. Young City in Yeongdeungpo-gu, for instance, has been sold at a yield of just 4.4%, which is reportedly the lowest achieved for a decentralised office asset in Seoul. Also, the Hyundai Marine and Fire Insurance Building has reportedly secured a record price of KRW34 million per pyung (3.3 per square metre (sqm)) in Gangnam, which represents a premium of 11.5% above the previous record of KRW30.5 million set by Samsung C&T Building in the third quarter of 2018. While we are cautious about the near-term outlook for office rents in Seoul (-1.6% p.a. over the next three years, versus. +0.3% p.a. in the past three), we expect the above-average yield gap of 2.7%pt (versus the average 2.5%pt for APAC offices) to remain relatively attractive to investors.

- **Industrial properties: keen investor interest to anchor lower yields.** Beside residential properties, investment activity in industrial properties has also held up relatively well year to date (-10.6% y-y in the first half of 2020). This is not surprising given the long-term secular trends that are favourable for the sector. One of the closely watched transactions in APAC during the second quarter of 2020, for instance, was the sale-and-leaseback deal that involved four Aldi distribution warehouses in Australia. The portfolio was first put up for sale in February, with an indicative price of AUD700 million, which reportedly translated into an initial yield of just 4.3-4.4%. The sale attracted interest from several institutional investors and, while the eventual winning bid is 7.4% below the initial indicative price (AUD648 million), it remains a robust price considering the pandemic. Also, new capital is being raised to be deployed into the Australian logistics property sector. Arrow Capital Partners, for instance, is reportedly creating a new AUD1 billion fund with Cerberus Capital Management to invest in logistics and industrial properties in Australia. This follows the launch of another AUD1 billion fund by ESR Cayman in late-March, which also targets the sector. We expect keen investor interest to anchor lower yields, despite the softer rental outlook in the near term.
- **Listed equity fund-raising: Australian real estate investment trusts (REITs) recapitalised balance sheets after a recovery in share prices.** On average, the share prices of listed real estate investment trusts (REITs) in APAC have gained 10.8% since the lows at the end of March. Accordingly, the average price-to-book (P/B) multiple has rerated to 1.1x (from just under 1x as at the end of March). Managers of listed REITs have therefore capitalised on this window of opportunity to bolster balance sheets by raising fresh equity from investors, especially in Australia. The amount of new equity raised by Australian REITs (A-REITs) to date in the second quarter of 2020 is just under USD1.8 billion, compared with only USD240.6 million in the first quarter of 2020. The bulk of the new equity raised during the second quarter of this year was represented by the AUD1.4 billion raised by the retail landlord Vicinity Centres in early June, following preliminary valuations that pointed to a loss of 11-13% in portfolio value. A similar write-down took place earlier in April for retail properties held by the GPT Wholesale Shopping Centre Fund (-11%). We expect the structural challenges facing retail properties in Australia to translate into further downside in capital values in the near term (-9.7% p.a. over the next three years, from +2% p.a. in the past three).
- **Debt funding: credit conditions have improved since the end of March.** In terms of bank financing to real estate, outstanding bank loans to the real estate sector in Japan gained 3.2% y-y to JPY82.5 trillion as at the end of March, according to recent data from the Bank of Japan (BOJ). Importantly, new loans to corporate real estate entities increased 2.1% y-y to JPY2.8 trillion in the first quarter of 2020, which represents the highest level since the second quarter of 2009. It appears banks are still keen on lending to the real estate sector in Japan, despite the BOJ's concern over the higher real estate loans to GDP ratio. Liquidity conditions have also loosened in the public debt market. As at the 15 June, the option-adjusted spread (OAS) of the Bloomberg Barclays Asia USD Investment Grade (IG) Bond Index and the High Yield (HY) Index was 2.09% and 8.16%, respectively. While the IG and HY OAS are still 89 basis points (bps) and 324 bps higher than their respective levels at the beginning of the year, they have tightened by 57 bps and 325 bps, respectively, from end-March levels when market sentiment was at its worst.

Chart 3: Transaction values for investment properties in APAC (excluding development sites; USD million)



* Preliminary estimate
Source: Real Capital Analytics, Aberdeen Standard Investments; June 2020

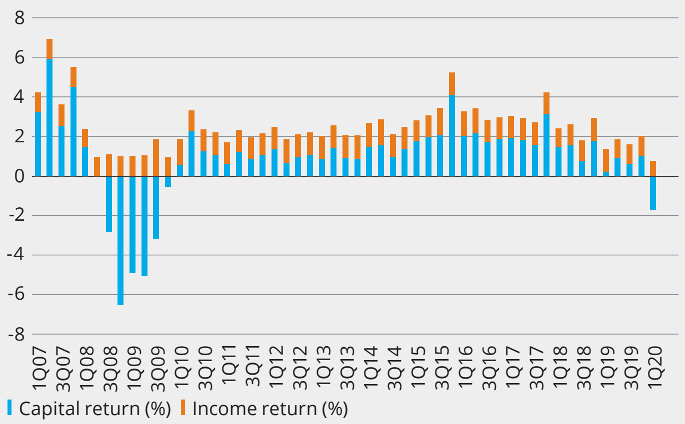
Performance and risk outlook

- **Non-listed real estate: first negative returns since GFC.** The Asian Association for Investors in Non-Listed Real Estate Vehicles (ANREV) published its quarterly index for the first quarter of 2020 on 17 June and the all-funds index returned -1.36% in the first quarter of 2020 (from +2.52% in the fourth quarter of 2019). This is the first time since the GFC that returns have been negative. All styles registered negative returns during the quarter: core funds -0.93% (from +2.03% in the fourth quarter of 2019), value-added funds -2.83% (from +6.59% in the fourth quarter of 2019), and opportunistic funds -4.35% (from +1.47% in the fourth quarter of 2019). The negative core return was principally driven by lower capital values (-1.69% in the first quarter of 2020, from +1.02% in the previous quarter; Chart 4), although the income return also narrowed to just 0.76% during the quarter (from 1.01% in the fourth quarter of 2019). Japan-focused funds are the only ones that registered a positive return during the quarter (+0.65%, versus +9.5% the quarter before).
- **Listed real estate: performance since February aligned to fundamentals.** Based on the share prices of the major listed REITs by sector in APAC as at 15 June, share prices of hotel REITs have fallen the most (-23.3%) since the end of February before the coronavirus-triggered market correction. This is followed by retail REITs (-16.5%) and office REITs (-14.8%). On the other hand, industrial REITs (+3.7%) and residential REITs listed in Japan (-0.9%) have seen relatively less drawdown. The performance is more or less aligned with the anticipated impact from the Covid-19 crisis on the fundamentals of the respective sectors.

"Concerns over the long-term prospects of offices may create opportunities in selected markets."

- **Total returns to remain under pressure in the near term.** We expect total returns for non-listed real estate in APAC to remain under pressure in the near term. We forecast an average total return of -0.3% p.a. for the region over the next three years (versus +8% p.a. in the past three) and we expect greater divergence in performance among the sectors. We expect outperformance in industrial properties (+6.5% p.a.) and multifamily rental apartments in Tokyo (+6% p.a.) to be balanced by underperformance in the retail sector (-6.5% p.a.). On a risk-adjusted basis, we believe the real estate market in Japan remains relatively attractive within the APAC context (we estimate total returns over the next three years of +2% p.a.).
- **Macro uncertainties remain the biggest risks.** The uncertainties in the macro environment continue to pose the biggest risks to our base case forecasts. This is especially if extreme lockdowns were to be re-imposed across multiple major markets, causing greater economic and financial volatility amid persistently depressed activity. Potential policy mistakes, coupled with a greater viral persistency than currently envisaged, could result in the speed of recovery being slower than what we currently expect in our base case. Also, a re-escalation in tensions between the US and China, and other geopolitical risks, is likely to complicate the macro picture for the APAC markets.

Chart 4: Composition of core returns (%)



Source: ANREV, Aberdeen Standard Investments; June 2020.

Investment themes

- **Core pricing has remained surprisingly firm…** This is especially the case for office properties in Seoul (where record prices have been achieved in Gangnam) and industrial properties, in general. We expect investors to increasingly narrow their focus on a few selected sectors, such as logistics, multifamily rental apartments in Japan's winning cities like Tokyo and Osaka, and core offices in selected gateway cities. The weight of capital is likely to keep property yields low for these sectors, despite the poorer near-term rental outlook. We think it is more likely for investors to secure softer entry prices for assets that come with higher leasing and management risks. For investors who are able to venture out slightly on the risk spectrum, we think a core-plus or a light value-added strategy may offer a better risk-reward proposition compared with a core strategy for now.
- **…but that does not rule out potential core opportunities in the next 12 months.** After all, it has been just three months since the global pandemic took a turn for the worse in late-March. Real estate capital values in APAC have historically lagged the stock market by nine months, on average. If new waves of infection were to force extreme lockdowns to be re-imposed, this would cause greater volatility in the economy and the financial markets.
- **Concerns over the long-term prospects of offices may create opportunities in selected markets.** The last three months have demonstrated that there are many job functions that can be satisfactorily performed away from the office. Given the expectation that the crisis will accelerate the adoption of flexible work arrangements by companies, investors are therefore concerned over the long-term demand outlook for office space. We think there are important differences between cities that need to be considered in assessing the long-term impact of flexible work arrangements on offices. For instance, we think the adoption could be slower in Japan (60% of its workforce still reported for work at the office during the state of emergency) and the demand for office space there may be less affected compared with other markets. As such, there could be opportunities for more discerning investors to pick up good-quality assets in markets, such as Japan, if investor sentiment for offices were to become more bearish.

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