M&G Real Estate

The tailwinds driving the Asia real estate market

As we look to the year ahead, the prospects for Asia Pacific are positive, supported by region-specific tailwinds for growth coupled with synchronized global economic expansion. The latter has emerged for the first time since 2010 and should bode well for global trade flows. It also sets the stage for further improvements to business sentiment in this export-led region, while Asian companies move toward more advanced manufacturing and increased intra-regional trade flows to service the increasingly wealthy population.

As with all economies, there may be some clouds on the horizon for investors to be cognizant of. Geopolitical risks, such as continuing tensions on the Korean peninsula and reports of the possibility of a U.S.-China trade war, are expected to persist and could have implications for businesses and investors in 2018. With China now appearing more committed to a stronger push for economic reform, a risk is that this leads to increased financial-sector supervision and a pullback in excessive credit expansion. Supervision could entail regulation of asset management products and new liquidity thresholds for small banks. However, we believe a credit shock is unlikely, as the government has highlighted financial stability as a top priority.

Against a backdrop of **strong economic growth, expected at 4.8 percent year-over-year in 2018,** there is increasing motivation for central banks to raise rates. In South Korea, which is expected to lead regional output growth this year (2.9 percent year over year), interest rates are expected to rise 200 basis points to 3.5 percent in 2022. This follows the Bank of Korea's recent first rate hike in six years of 25 basis points to 1.5 percent. While interest rates have already started to rise, some economies are still likely to remain cautious. Japan, for example, remains committed to its zero interest rate policy (ZIRP) in its continued effort to revive the domestic economy.

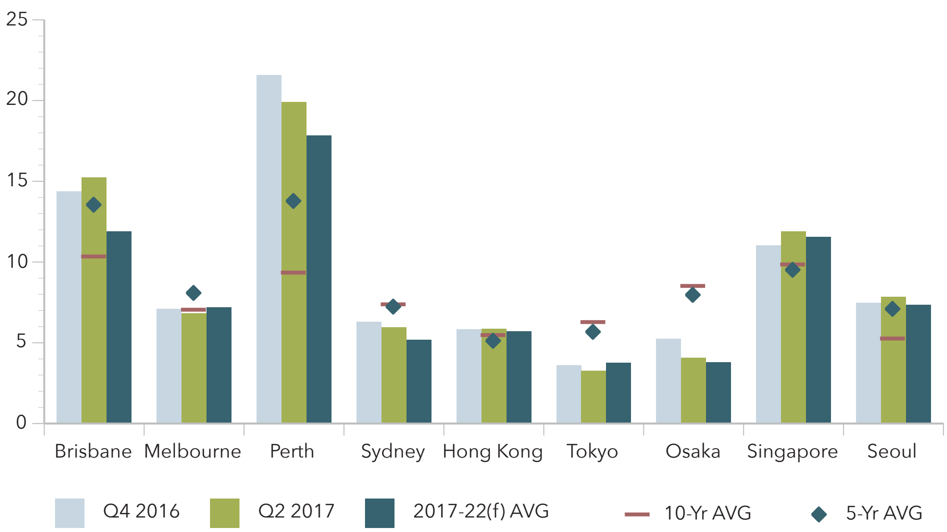
The **positive macroeconomic environment has supported investors' growing appetite for commercial real estate in Asia Pacific,** whether to tap into this growth potential or for diversification purposes. We expect transaction volumes to remain around the current levels, hovering between the relatively high five-year average and the 10-year long-term average, creating high liquidity in the market.

The uplift in business sentiment, coupled with the attractive economic growth expected in 2018, should support healthy occupier demand for the regional office markets. Therefore, office market vacancy rates are expected to decline, with higher rental growth forecasted in markets with vacancy rates below their five-year averages. Singapore is likely to see the strongest overall rental growth over the next three years, with around 5 percent to 6 percent per year (according to our forecasts), driven by restricted class A supply in the medium term.

A similar lack of class A office supply in the Australian cities of Sydney and Melbourne should continue to support relatively robust rental growth over the next 18 to 24 months, as well as in the regional city of Osaka, Japan, which has a –3 percent vacancy rate. Looking further ahead, however, Sydney, Melbourne and Tokyo may see downward rental adjustments due to pressure from new completions offering occupiers more options and, therefore, leverage to negotiate lower rents.

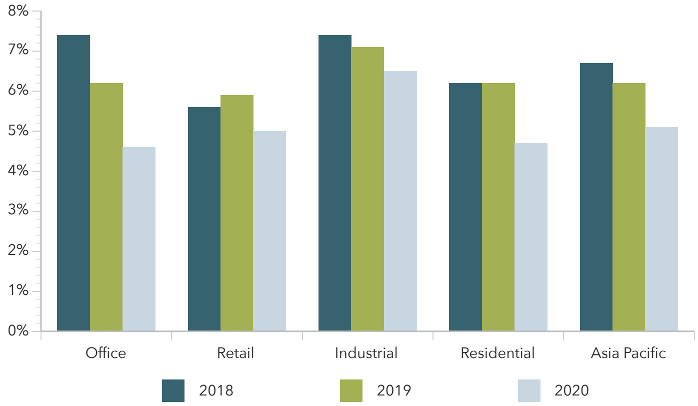
Across Asia Pacific, tech-related industries and business services are expected to remain active, and **competition for talent may drive continued recentralization back to more prime CBD locations.** This stronger expansion appetite of tech-related occupiers is creating a polarization in the Seoul office market between the slowly recovering CBD and the already strengthening Gangnam (GBD) submarket. Tech companies prefer the latter submarket, while the more

Overall Asia Pacific office market vacancy rates expected to decline



Source: M&G Real Estate Research based on data from PMA and internal forecasts, as of October 2017

Asia Pacific total returns for major market-sectors 2018–2020(f)



Source: M&G Real Estate Research based on internal forecasts, as of October 2017

cautious blue-chip firms reside within the CBD. However, with the strong pick-up in South Korea's economy, there may be more appetite in the CBD for expansion, or relocation to the CBD, over the next one to two years. Against a backdrop of many real estate market yields trading at historical lows, the Seoul office market offers an attractive yield spread of 220 basis points over the 10-year average bond yields and scope for cap rate compression.

Both the retail and logistics sectors are experiencing structural disruption across Asia Pacific due to the growth of e-commerce. However, the pace of growth is expected to slow over the next five years to single digits by 2020–2021 in the developed markets of the region, and the disruption experienced by retail may begin to ease over the medium term. Retailers are also coming to terms with the evolution of retail by focusing more attention towards becoming omni-channel, further alleviating this pressure.

Improvements in consumer sentiment and continued growth in regional tourism should have positive implications for the region's gateway cities. Hong Kong is expected to see relatively stronger rental growth of around 3.2 percent per year over the next three to five years, as retail rents start to recover following the steep decline over the past two years. Similarly, Singapore retail rents should start to rise by around 1.5 percent per year. The positive effects of residential en bloc sales in Singapore may boost further consumer spending, as sellers cash out and redeploy this money elsewhere. However, a potential goods-and-services tax hike this year or next could restrain spending initially, as consumers adjust to the new level.

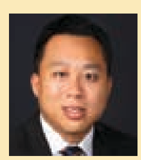
With relatively stronger population growth, Australia's retail market should continue to be supported by growth in aggregate consumer spending. In Sydney and Melbourne, retail rents are expected to grow between 2 percent and 3 percent per year over our five-year forecast period to end-2022.

The organic growth from e-commerce coupled with retailers expanding their omni-channel capabilities is supportive of continued demand for logistics warehousing. However, given the supply response in the face of growing demand, there may be some markets that need time to work through existing or new logistics stock where completion levels are high, such as Singapore and Osaka. The entrance of Amazon into Australia in late-2017 should also lead to increased demand for logistics warehousing space over the medium term.

Older warehousing stock in more strategic locations may see heightened demand, as last-mile delivery demand steadily increases, alongside the aging population in Asia set to contribute to growing appetite for more delivery services. Overall, logistics rents should see relatively steadier rental growth that is at least in line with inflation, while better-located assets are likely to see stronger rental growth.

Total returns for the industrial sector are forecast to be the most attractive, at about 7 percent per year over the next three years. Australia and South Korea look relatively more attractive due to low cap-rate compression and their relatively higher yields of 5.5 percent to 6.0 percent. The total return for Seoul's logistics market is forecasted to be the second highest, at 8.2 percent per year after Singapore (8.3 percent per year) for 2018 to 2022.

Given that the majority of real estate yields are trending along historic lows, rental growth may make up a greater proportion of total returns going forward. In 2018, total returns may look relatively muted in comparison with the recent three years of strong capital value growth due to steep cap-rate compression. While Asia Pacific real estate is expected to deliver a total return of around 6 percent per year over the next three years on average, the portion of returns from capital value is expected to contribute less than one-third of that. Therefore, active asset managers choosing the right assets in the best locations and utilizing a mix of strategies to increase rental growth are likely to achieve the best returns for their clients.



Contributor:
Jonathan Hsu
Head of Research, Asia
M&G Real Estate

For more information, please contact
Placement Agent:
John F. C. Parsons, Managing Director
MacGregor Global Investments
+1 312-274-6800
jparsons@macgregorinvestments.com

[1]Bloomberg consensus economic forecasts, as of December 2017 [2]M&G Real Estate Research based on data from Oxford Economics, as of December 2017 [3]M&G Real Estate based on data from Euromonitor, as of December 2017.