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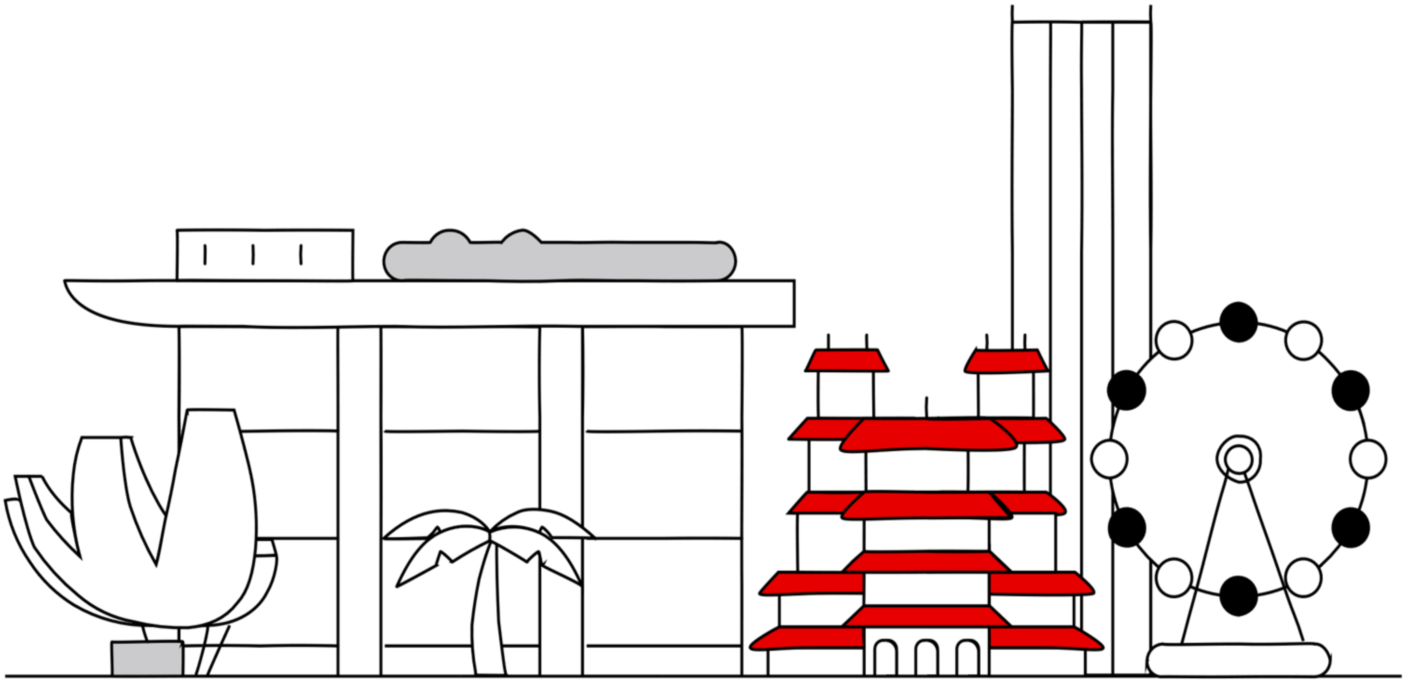
Real Estate Outlook – APAC



Seeking shelter.

UBS

UBS Asset Management

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"APAC economic growth accelerated in 3Q22 as China rebounded. Growth should slow, but the region is expected to hold up better as the US and Europe enter recession in 2023. Wide bid-ask spreads remained a hurdle for deal closings. Cap rates loosened slightly and will move out further in the next 1-2 quarters. Japan still offers attractive opportunities."

Leading the pack

APAC GDP growth accelerated to 4.8% YoY in 3Q22, largely driven by the rebound of China (+4%). Even without its boost, the regional performance was stable as the tightened monetary condition takes its time to feed through. Weaker external demand and increased energy import prices eroded trade balance, but the impact was mitigated by robust private consumptions from post-pandemic spending.

Inflation continued to climb in 3Q22 and was up 0.6 percentage points QoQ to 5.5%. However, the momentum is slowing and there are signs of peaking. Energy prices have retreated and supply chain bottlenecks are easing. In the US, inflation has moderated for four consecutive months from 9.1% in June to 7.7% in October. The Fed has hinted at the possibility of a slower rate hike, albeit at a higher terminal rate. In APAC, Singapore, India, Taiwan, Malaysia, Indonesia and Thailand saw lower inflation in October. Australia started to slow its pace of rate hike from 50bps to 25bps even before any domestic data showing a cooldown. Its 275bps increase since May is significant, but the full effect has yet to be felt. Reserve Bank of Australia (RBA) deems a smaller rate hike to be prudent as it engineers a soft-landing. Overall, there is a small hope that the finishing line of interest rate upcycle is finally within sight.

Nevertheless, a victory against inflation, while positive, is not without costs. A cyclical downturn ensues. UBS Investment Bank expects a recession in the US and Europe in 2023. Global inflation should peak in 4Q22 to an average 8.6% for the year before moderating to 5.6% in 2023. Correspondingly, interest rates are forecast to top out in 1H23 with potential rate cuts in 2H23, as the narratives shift to reinvigorating the economies.

For APAC, growth could slow, but it appears likely that the region may avoid a recession. There are two main reasons backing this up. Firstly, the inflation war in this part of the world has been less intense. Secondly, the reopening of China will also lift aggregate demand. In fact, China and Hong Kong are the only countries expected to deliver a growth acceleration in this region. This said, this growth engine is not expected to recover to its pre-pandemic glory due to weaknesses in external demand and its property sector.

We believe a peaking of inflation and interest rates would also spell good news for Japan's diverging monetary policy. This should allow the Bank of Japan (BoJ) to maintain its stance at least for the near term. APAC currencies, which have depreciated 5-22% YTD, should also be poised for a reversal.

Wide bid-ask led to market lull

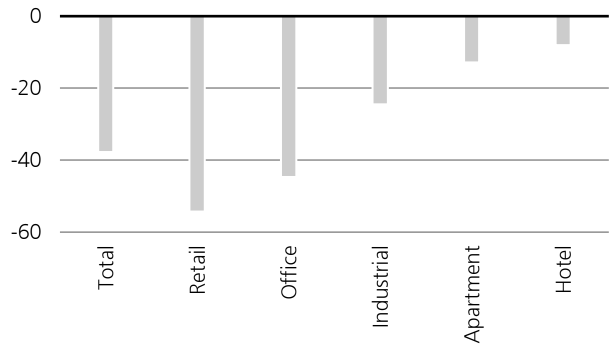
APAC leasing activity in 3Q22 slowed down expectedly on the back of macro uncertainties. According to CBRE, office net absorption softened 11% QoQ, while logistics normalized from its pandemic high. Retail fared better thanks to reopening tailwinds boosting retail sales. We expect the overall leasing sentiment to weaken further in the coming quarters as the economy enters a period of slower growth.

In contrast to the occupier market, the swings in the 3Q22 investment volumes were more drastic. Elevated funding costs remained the sticking point, and deals are hardly accretive at current pricing. The allocation cap driven by falling equities and bond prices added to the pressure and held back capital deployment in real estate.

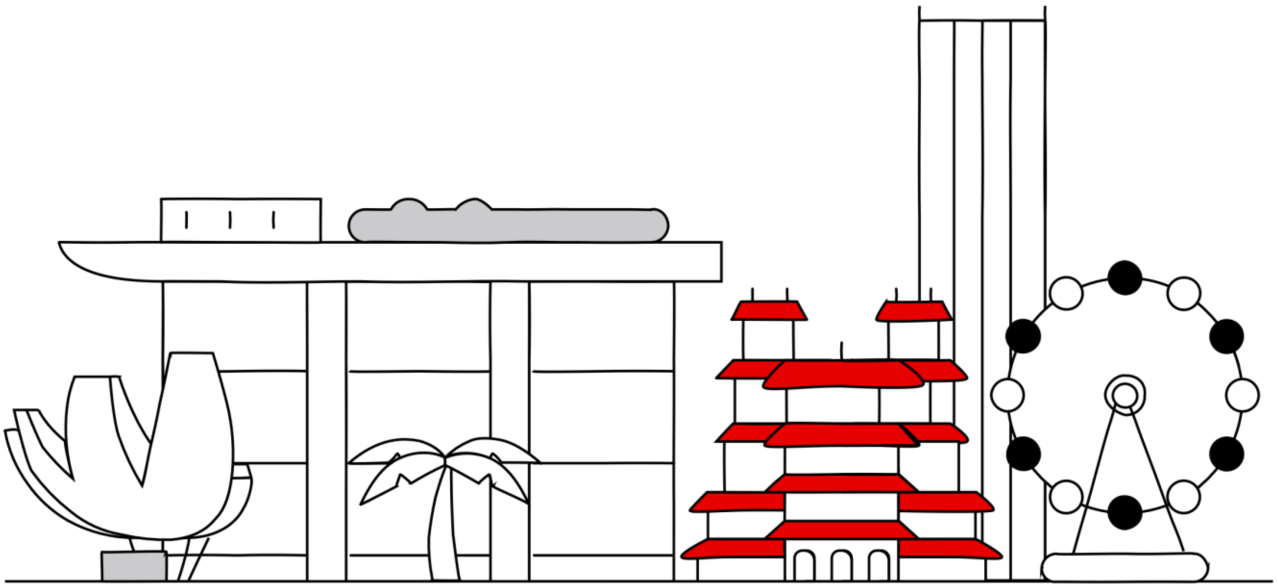
According to MSCI, transactions fell 38% YoY to USD 32.6 billion (see Figure 1), below the pandemic trough and the lowest since 2016. By sector, office and retail were the worst performers with volumes -45% and -54%, while hotels and apartments were the best at -8% and -13%. Industrial / logistics volume was surprisingly resilient at -24%, though it was distorted by a large deal by JD.com in China. Excluding that, logistics volume declined more than half YoY. By country, most markets recorded a decline except for Singapore (+30%) and India (+79%). Japan was not spared and fell 61% (-45% in JPY terms) despite its conducive interest rate environment, as REITs were relatively quiet during the quarter. Larger transactions including Otemachi Place (USD 2.8 billion) will be finalized in 4Q22 and hence not included in 3Q22 numbers.

Pricing is starting to soften in APAC though not to the extent of the US and Europe. Real Capital Analytics data showed a minor uptick in cap rates in 3Q22, especially in Australia and South Korea. This is not a surprise as their monetary tightening has been more aggressive. MSCI data also showed an expansion of valuation cap rates in 3Q22 for Australia logistics. That said, the movements so far have been marginal and less than 50bps. More is likely to come. Based on a CBRE survey in October, 58% of respondents expect cap rates to move out by 25-100bps in the next six months. Australia seems most vulnerable with indicative expectations vs. March 2022 pointing to a 25-75bps expansion, while Japan cap rates are expected to remain stable.

Figure 1: Asia Pacific transaction volume YoY change (3Q22, %)



Source: MSCI, November 2022.



Japan could provide shelter

Elevated funding costs and negative yield spread continue to dominate key debates for real estate. Bond yields have retraced from the October high but remained sensitive to the Fed's comments. Predicting near-term movement may be fruitless, but the general consensus is for 2023-24 yields to settle at lower levels than current, but higher than 2019. At such levels, cap rates will need to adjust higher from present for the returns profile to normalize. Potential sellers have been able to hold out so far, but this could change as refinancing bites into returns. Disposals could also be motivated by fund expiries, withdrawals, portfolio reallocation and potential gearing breach from write-downs.

Without a liquidity shock, the adjustment process could take time. In that environment, dry powder is likely to find shelter in any accretive deals available. In our view, Japan appears as a clear winner given its large yield spread. Indeed, there has been increasing interests of late driven by this favorable relativity. Hailing from Singapore, Keppel REIT made its first Japan acquisition in October and targets to increase exposure to bolster its inorganic growth. Hong Kong-based Gaw Capital articulated its intention to deploy up to USD 4 billion in the country over the next two years, while the US-based KKR is also attracted by the cheap JPY.

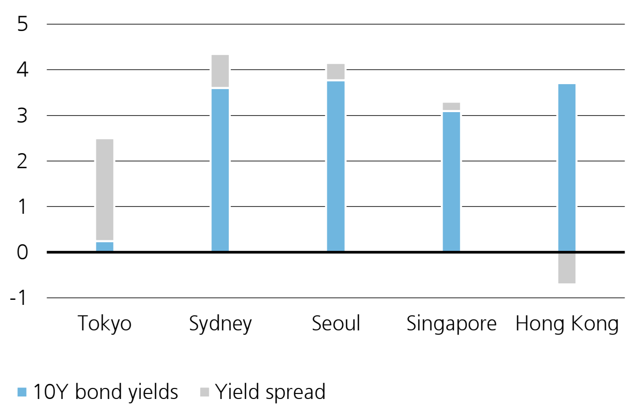
Japan holding its own

Japan is the only market where pricing expectations are still holding firm. In September, a huge office transaction was done at an eye-catching 2% cap rate, implying further cap rate compression (see Figure 2). Our conversations with brokers also suggest potential yield tightening for multifamily assets. It is indeed an outlier market in the current environment driven by the BoJ's continued loose monetary policy. The question often asked and hotly debated is about its sustainability and whether Japan will eventually fall in line with the rest of the world.

BoJ and the Japanese government showed a united front to defend the policy as the economy is still considered weak. BoJ reiterated its stance in September and October, but was met with intense market pressure as the US continued to raise rates. Japanese government bonds were sold down and the Japanese yen depreciated sharply to a 32-year low of 151 against the USD. The Ministry of Finance intervened in the FX market for the first time since 1998 in support of the currency and indirectly BoJ's stance. So far, USD 19.7 billion and USD 42.8 billion were spent in September and October to keep the currency stable.

We expect the policy to stay on hold at least until the end of the current BoJ governor's term in April 2023. While the consensus expectations are for policy continuity for the whole of 2023, there are some observers expecting some form of policy tweaks such as adjustments to the yield curve control. We think the possibility will hinge on the US Fed's action, which has been the chief driver of JPY weakness. Indeed, its recent softening of tone has resulted in JPY/USD strengthening to 139 in early-November. Barring a hawkish guidance in the coming months, we see little urgency for BoJ to pivot. Inflation is a risk but seems unlikely to surprise expectations for now. As the US economy cools in 2023, we see a potential for further JPY appreciation. In real estate, multifamily is our preferred sector while we also expect office to attract capital despite its weaker outlook.

Figure 2: APAC office yield spreads in 3Q22 (%)



Source: PMA; Reuters. Note: bond yields as of 22 November 2022.

Increasing interests in niche sectors

Given limited opportunities in traditional sectors in the current environment, some investors are allocating capital into niche sectors. In particular, life sciences and self-storage saw increased appetite. APAC is jumping on the bandwagon in an attempt to replicate western success in these areas. For example, CBC Group-APG JV recently made its third investment in China for their USD 1.5 billion life sciences venture. Lendlease-PGGM JV's which has a USD 780 million strategy targets APAC innovation and life sciences properties. For self-storage, CapitaLand Investment recently won a USD 810 million mandate from APG and the JV has acquired Extra Space Asia as its seed investment.

These sectors are at their nascent stage in APAC and have a positive structural story. Investors may be able to generate alpha through early-mover advantage if executed well.

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