abrdn Asia-Pacific Real Estate Market Outlook

Q3 2023

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Executive Summary

- Activity, especially in services, and underlying inflation have been more resilient than expected in several markets, led by the US. Our view remains that a recession is necessary for inflation to return to target-consistent levels, following which policy easing could begin. The timing of this has however been pushed back to early 2024 (from H2 2023). Apart from Australia, we judge the overall interest rate outlook in APAC to be more benign that the Western DMs. More policy easing is expected in China while Japan's policy settings are expected to remain accommodative despite our expectation for the YCC policy to be tweaked.
- Besides a relatively more benign interest rate outlook, APAC's office occupier market also appears to be in a better shape, compared to its Western DM peers, on account of a faster return to office post-Covid (ex-Australia). The better outcome in terms of workers' return to office in turn has mostly to do with structural factors, such as smaller living space per person and a more affordable and efficient office commute, in Asia's key cities. That said, our estimates suggest vacancy risk remains a threat in several office markets over the next three to five years. Seoul, Singapore, and Mumbai may be the exceptions here.
- Property yields in Australia and Korea have risen the most in APAC, especially for warehouses and offices. While investment sentiment is cautious and prices have adjusted, especially in the case of Sydney and Melbourne CBD offices as well as Greater Seoul logistics, recent transactions do not suggest there is widespread distress yet. In the case of Sydney and Melbourne CBD offices, some of the wider discounts to book values transacted could be attributed to asset-specific issues, such as low occupancy and building age. This supports our thesis that a faster price correction in Secondary Grade assets will create opportunities for ESG upgrades.
- We expect capital returns of real estate investments to remain under pressure over the next 12 months. This is especially the case for market/sectors such as Sydney and Melbourne CBD offices as well as Greater Seoul logistics where the short-term occupier market fundamentals are also poor. Beyond the immediate 12 months, we expect lower interest rates to support better capital returns, especially in market/sectors such as Seoul and Singapore offices where the occupier market outlook remains solid despite the coming recession. The outlook for interest rates remains a key risk for real estate's near-term performance.

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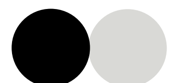
APAC economic outlook

Activity, especially in services, and underlying inflation have been more resilient than expected in several markets, led by the US. This means that central banks, especially those in the Western Developed Markets (DMs), will likely have more tightening to do in the near term. Our view remains that a recession is necessary for inflation to return to target-consistent levels, following which policy easing could begin. The timing of this has however been pushed back to early 2024 (from H2 2023).

We judge the overall interest rate outlook in Asia-Pacific (APAC) to be more benign than the Western DMs, with Australia being a notable exception:

- In China, the reopening rebound has faded fast. Unlike other markets, Chinese inflation remains muted and shows little sign of moving above target as the economy settles into endemic living. The surprise cut to the 7-day reverse repo rate in June was indicative of the authorities becoming increasingly concerned with the faltering rebound.
- In Japan, while consumer strength should continue to support growth in the coming months and fuel speculation over domestically generated inflation, the spillovers from a US recession that we expect to hit in early-2024 will weigh on growth. The BOJ continues to view current inflation as transitory and has left policy settings unchanged. Our base case remains that the YCC policy will be tweaked in July, but the overall policy settings should remain accommodative (Chart 2).
- While labour demand indicators continue to soften gradually in Australia, the labour market itself is still near record tight levels. Indeed, the RBA Deputy Governor has warned that the unemployment rate may need to rise to 4.5% (from the near 50-year lows of 3.55% as of May) to tame inflation. Following the surprise hike of 25bp in June, many observers expect the RBA to remain on a tightening path.



APAC economic outlook

	2020	2021	2022	2023	2024	2025
Real GDP growth (%)						
- China	2.2	8.4	2.0	5.6	3.2	5.9
- Japan	-4.3	2.2	1.0	0.7	-0.6	0.7
- India	-5.8	9.1	6.8	5.9	4.2	6.2
CPI (average; %)						
- China	2.5	0.9	2.0	1.0	2.8	2.8
- Japan	0.0	-0.2	2.5	2.5	1.2	1.0
- India	6.2	5.5	6.7	5.0	3.1	5.7
Policy rate (YE; %)						
- China	2.2	2.2	2.0	1.8	1.7	1.6
- Japan	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
- India	4.0	4.0	6.3	6.5	4.8	6.0

Source: abrdn Research Institute; June 2023
Forecasts are a guide only and actual outcomes could be significantly different

APAC real estate market overview

Besides a relatively more benign interest rate outlook, APAC's office occupier market also appears to be in a better shape, compared to its Western DM peers, on account of a faster return to office post-Covid (again, ex-Australia). The better outcome in terms of workers' return to office in turn has mostly to do with structural factors, such as smaller living space per person and a more affordable and efficient office commute, in Asia's key cities. That said, our estimates suggest vacancy risk remains a threat in several office markets over the next three to five years. Seoul, Singapore, and Mumbai may be the exceptions here.

Property yields in Australia and Korea have risen the most in APAC, especially for warehouses and offices. While investment sentiment is cautious and prices have adjusted, especially in the case of Sydney and Melbourne CBD offices as well as Greater Seoul logistics, recent transactions do not suggest there is widespread distress yet. In the case of Sydney and Melbourne CBD offices, some of the wider discounts to book values transacted could be attributed to asset-specific issues, such as low occupancy and building age. This supports our thesis that a faster price correction in Secondary Grade assets will create opportunities for ESG upgrades.

Occupier market fundamentals continue to guide our market/sector preference and we are most constructive on the following:

1. **Seoul offices:** Occupier market fundamentals remain solid with record low vacancy amid limited near-term supply and robust leasing demand from domestic ICT (information and communication technology) firms. While new supply pipeline is expected to pick up in four to five years' time, we expect vacancy to remain tight relative to history even with conservative assumptions.
2. **Australia industrial/logistics:** Record low vacancy of 1% or less in many of the capital cities will continue to support rent growth, albeit at a slower pace. As well, we expect the expanding yields to translate into more attractive entry points for investors as interest rates continue to climb.
3. **Singapore industrial/logistics:** Limited near-term supply and robust storage demand for modern ramp-up facilities is supportive of further rental growth, notwithstanding a weak external environment for trade. This remains one of the few market/sectors in the region where the yield still offers an attractive positive carry to borrowing cost (even though it comes at the expense of a shorter land tenure). We expect the sector to continue drawing investment capital seeking income return.

APAC real estate market trends

Offices:
The overall rental decline across the APAC markets we track accelerated to 2.5%y-y in Q1 (from -1% in Q4), on the back of a higher vacancy rate of 11.9% (from 11.8%). The weakness was led by the office markets in Shenzhen (-8.4%), Tokyo CBD Grade A (-6.4%), HK (-4.7%) and Beijing (-2.3%). It appears market optimism at the beginning of 2023 for a near-term rebound in the Greater China occupier markets, following the reopening post-Covid, has now given way to more caution. Indeed, per CBRE's latest report on leasing sentiment in APAC, HK registered the sharpest deterioration in occupier sentiment in Q2 while sentiment in Mainland China remained the most negative in the region.

In Tokyo, the near-term outlook for CBD Grade A office vacancy remains challenging on account of new supply scheduled for completion in H2 2023. That said, tenants' flight-to-quality suggests vacancy risk could be increasingly concentrated in the older buildings. Per Nikkei's office rent survey for H1 2023, rents for new buildings less than a year old increased 4.2% - the first y-y rise in the first half in three years, outperforming rents in the existing buildings which fell by 1% during the same period.

Logistics:
The industrial/logistics occupier market continues to outperform even as economic headwinds strengthen across the APAC region. The pace of y-y rental growth picked up marginally in Q1 to 11.8% (from 11.6% in Q4) even as the average vacancy rate expanded to 4.6% (from 3.7%) during the quarter. The market remains the tightest in Australia, where the average rental growth accelerated to 25.9%y-y in Q1 (from 23.6%), while the vacancy rates in Seoul, Tokyo and Singapore increased the most during the quarter.

In the case of Greater Seoul, the significant volume of speculative cold storage completions in the near-term continues to weigh on the overall industrial/logistics market. Some investors, including reputable domestic names, have reportedly decided to walk away from forward purchase agreements signed earlier. While the near-term outlook remains challenging as the market digests the new supply, the longer-term fundamentals for Greater Seoul logistics properties remain solid, in our view, principally on account of Korea's high adoption of e-commerce. Per Samsung Securities' estimates, every KRW1trn increase (0.6% of total online sales of goods in 2022) in domestic e-commerce market would require an additional warehouse space of 35k py (3.3 sqm; 0.75% of total logistics space in Greater Seoul as of end-2022).

Retail:
The overall prime retail rents in tracked APAC markets gained 1.7%y-y in Q1 - a faster pace vs. the 0.4% increase in Q4. As well, the average vacancy rate narrowed further to 7.1% (from 7.3%) during the quarter. The improved occupier performance in Q1 was led by Tokyo (+9.2%) and Singapore (+11.1%) as tourism continues to recover from the pandemic. The total visitor arrivals to Singapore in May had climbed further to 75% of 2019 levels (from 71% in April) while, in Japan, the number of foreigners who arrived in May was 72% of the pre-pandemic levels (89% if Chinese visitors were to be excluded).

We expect household spending to come under increasing pressure from higher costs of living, which will pressure the outlook for retailers. This is especially the case in Australia where the outlook for interest rates appears to be more hawkish than most other key markets in APAC. That said, investment demand for non-discretionary retail assets, such as those anchored by large supermarkets with a relatively long WALE (weighted average lease expiry), appears to have held up. This is especially the case in Brisbane, where neighbourhood centres' average yield remained relatively stable in Q1, compared to an increase of 20bp q-q nationwide.

Living:
In JPY terms, Japanese multifamily assets' transaction volume gained 13.1% in the year to March 2023, outperforming the overall Japanese market's 1.4% loss. Japanese multifamily assets remain one of the few commercial real estate market bright spots and there is no sign of slowing interest. As competition for assets remains keen, investors are likely to move up the risk curve. Potential strategies may involve redevelopment of older apartments or offices. In June, the Legislative Councils' subcommittee on sectional ownership law published an interim draft, which could pave the way for more redevelopment of older condos by easing the requirements for such redevelopments to proceed.

Australia's apartment rents continued their ascent in May, albeit at a slower pace, as migration and limited supply kept vacancy low. We believe the outlook for the nascent Australian residential Build-to-Rent (BTR) sector remains solid given the favourable occupier fundamentals and recent tax changes to encourage new developments. Policy risks are however on the rise as policymakers come under increasing pressure to keep housing affordable. Queensland, for instance, will implement new rules from July 2023 that will limit the number of rent increases to once in a 12-month period, overriding pre-existing rental contracts that may have agreed to more frequent ones.

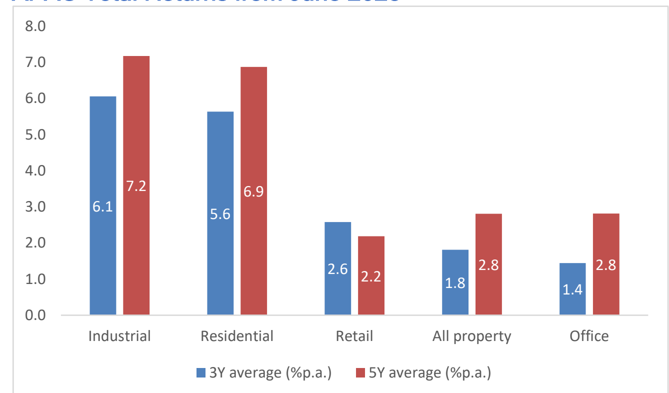
Outlook for risk and performance

While our base case remains that the overall interest rate outlook is more benign in APAC (ex-Australia), compared to the Western DMs, capital returns of real estate investments will continue to be challenged over the next 12 months. This is especially the case for market/sectors such as Sydney and Melbourne CBD offices as well as Greater Seoul logistics where the short-term occupier market fundamentals are also poor. Beyond the immediate 12 months, we expect lower interest rates to support better capital returns, especially in market/sectors such as Seoul and Singapore offices where the occupier market outlook remains solid despite the coming recession.

Macroeconomic drivers will continue to have an outsized impact on real estate's near-term performance and the risks to our base case include:

1. On the downside, a "No landing" or a "Fed has two bites of the cherry" scenario, whereby inflation remains elevated, and policymakers are forced to rapidly tighten again after a pause. This would imply elevated interest rates for longer. Importantly, we think this could also result in a later but deeper recession.
2. On the upside, a more significant policy easing in China than what we are currently expecting could more forcefully unlock household and market confidence. This would provide a near-term boost for assets in Greater China as well as Singapore and Korea. The flipside however is that the consequent higher inflation suggests any upside in rents could be more than offset by lower capital values as borrowing costs are kept higher for longer.

APAC Total Returns from June 2023



Source: abrdn June 2023
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Sector conviction themes and portfolio tilts

Sectors	Alternatives	Industrial & logistics	Residential (PRS/BtR)	Retail	Offices
Allocation tilt	↗	↗	↗	↘	↘
Conviction within segments	Healthcare Life sciences Student Accommodation Serviced Accommodation Caution: Low tier PBSA; older data centres with ESG pressures	Urban logistics e-fulfilment & mid-box Caution: Big box let to discretionary retailers; older buildings; inefficient buildings	City centre and fringe locations, AAA rated BTR / PRS, mixed use Caution: poor efficiency; poor layout; luxury; regulation possible	Supermarkets, non Fashion Retail Parks Convenience / grocery Caution: Shopping C's, luxury high streets	City centre, constrained No compromise on location – follow "FACTS" guidelines Caution: short income; business parks; weak EPC
Potential risk strategies	Diversification of value drivers Long income	Core assets, value add in best locations Longer or short income Indexation	Core assets / repositioning Longer income (leased) Indexation	Longer income Indexation Dominant schemes Retail park reposition	Core assets / long income Value add and ESG uplift
Key risks	Operational risk / costs Changing legislation Indiscriminate capital inflating values	Tenant quality Mispricing of risk in strong market conditions Global economy/supply chains	Rent regulation Operating costs Reputational risks Sudden supply increase	E-commerce Revenue linked lease terms Weaker household incomes	Higher volatility of income Long term structurally lower demand possible

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