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Down a rabbit hole?

Real estate musings in the year of the Rabbit

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2023, the year of the Rabbit, is said to be a year of hope. It is an apt position to take as we navigate the challenges ahead.

The Asia-Pacific region is seen as a safe haven by global investors, but we are not immune to the headwinds facing the global economy, and asset prices will inevitably be impacted. The question is, can we avoid falling down the rabbit hole?

2023 兔年

Year Of The
RABBIT

Navigating the real estate pitfalls in the year of the Rabbit?

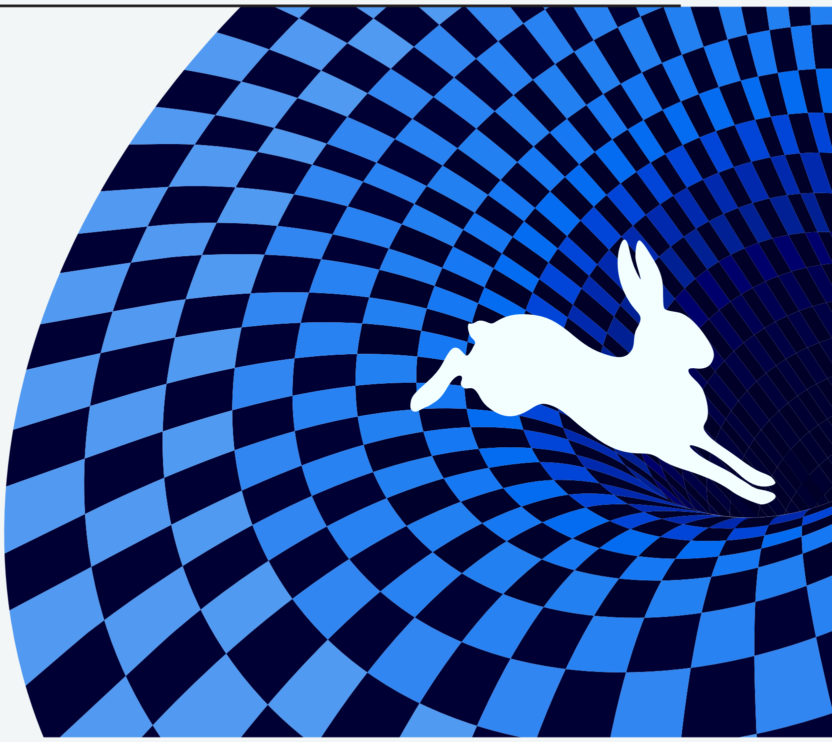
Global real estate markets endured a rather tumultuous Year of the Tiger. Geopolitical tensions and macroeconomic challenges prevented the economic recovery which was widely anticipated during the earlier part of 2022.

Arguably, many Asia Pacific markets ended the year on a relatively positive footing. Effective pandemic management and the orderly resumption of mobility and business activities led to less acute inflationary pressures despite the surge in global energy and commodity prices. There is a growing consensus that Asia Pacific is emerging as a relatively safe harbour in these turbulent times because it is at such a different stage in its economic cycle, with fewer obvious headwinds.

That said, we step into the Year of the Rabbit with as much trepidation as confidence. There is no doubt that the current state of the real-estate markets is unique. Across the world, real-estate values are under significant pressure from interest rate hikes after an extended era of yield compression. Price discovery is vague, at best, amidst the ambiguity around costs, rates, and end-user demand. There has been an awkward slowing in transaction volumes which has affected overall sentiment. Yet, despite all this, many property markets still delivering resolute rent growth, particularly in undersupplied sub-markets and segments. We are convinced that this year still offers much hope and promise for the astute investor who has the expertise to assess individual properties on their relevant merits.

In the much beloved classic, Alice's Adventures in Wonderland by Lewis Carroll, the protagonist Alice gets sucked into an alternate reality when she stumbles down a hole during her rash pursuit of a scurrying White Rabbit. Here, we offer a tongue in cheek segue into our key views for real estate in the Year of the Rabbit. We are aptly reminded of parallels that can be drawn between the current world we operate in and that of Alice's Wonderland. Importantly, the White Rabbit and its many peculiarities present some useful learning points for real-estate investors in this Year of the Rabbit.

Down the rabbit hole?



The rabbit hole went straight on like a tunnel for some way, and then dipped suddenly down..."

The rabbit hole is an appropriate metaphor for the real estate markets in this year. No one has an absolute sense of the extent and magnitude of the ongoing yield expansion. In the US and parts of Europe, commercial property valuations started to adjust last year, largely in response to interest rate hikes by major central banks. To what extent will pricing come off from current levels? As inflation continues to rear its ugly head, it is possible that hawkish sentiments could persist into the rest of the year. Indeed, the rabbit hole could run deep.

The case for APAC real estate markets is not entirely different. We know the increase in risk-free rates will ultimately have to pass through to real-estate valuations. That is no exception in most of Asia, but the jury is still out on the extent and timing of real estate repricing. Markets such as Australia and South Korea have been pre-emptive in the fight against inflation and have responded with several rounds of interest-rate adjustments. While commercial real-estate yields have thus far only moved sideways – which is a sign of the region's resilience and capital appeal - expectations are for property yields to inch up this year.

There are two reasons why we believe the rabbit hole might just provide a gentle landing point for APAC in the Year of the Rabbit. Firstly, price pressures are mounting but the primary causes of this inflation are not permanent; the rising headline inflation in most of Asia is largely the result of supply-side issues, and inflation is expected to start easing this year.

After large-scale layoffs in 2020, employers in the US and UK must now pay significantly higher wages to attract and retain workers, which is not so much the case in Asia Pacific. While we are not in a demand-led inflationary situation, interest rate hikes in the region have nevertheless been front-loaded, but less aggressively so than in Europe and the US.

Secondly, rent growth remains resilient. In supply-constrained markets such as Singapore, office occupier demand is likely to stay high despite a slowdown in leasing by tenants in the technology sector. Even in some markets that have seen aggressive interest rate hikes, rent growth is likely to compensate, in part, for the outward shift in yields. For instance, we expect the aggregate office capitalization rate in Seoul to expand by around 30 to 40 basis points over the next two years. At the current level of yields, rents will have to increase by around 8% to offset the pass-through of this cap rate expansion to capital values. With annual rent growth forecast to come in at between 8% to 12%, the Seoul office market is expected to remain steady.

The variety within the APAC region throws up a myriad of opportunities. Even as we pursue the Rabbit and attempt to navigate the rabbit hole, investors in APAC, unlike Alice, are likely to find a softer landing.

The White Rabbit is hasty but circumspect

`Oh dear! Oh dear! I shall be late!'

`Not yet, not yet!' the Rabbit hastily interrupted.
`There's a great deal to come before that!'

A central but often inconspicuous character in the story, the White Rabbit shows up infrequently and moves the plot along. Notably, it appears to be always in a rush although it is habitually guarded. Similarly, in the Year of the Rabbit, we are convinced that investors should not be rushing into investment decisions. This year is a time for careful consideration and prudence.

Some office landlords plan to switch from long-lease tenures to a higher proportion of shorter leases, with the view of capturing rent growth alongside rising inflation. We caution that price pressures in APAC are not solely demand- driven. This caps the degree of rent increases that can be extracted from cost-conscious tenants. Also, most existing long-tenure leases, such as in Australia, already offer moderate rent step-ups in the range of 2.5% to 4%. In the industrial sector, however, structural tailwinds are strong. In this segment, we believe shorter leases in urban logistics could allow logistics owners to capture ongoing rent revisions across most APAC markets.

The other fast-emerging theme in real estate pertains to the increasing pressure on asset owners to jump on the ESG bandwagon. The EU's Sustainable Finance Disclosure Regulation (SFDR) level 2 rules came into effect at the beginning of 2023. While some may argue that SFDR requirements are less relevant outside of Europe, the reality is that most APAC investments made by European investors require stringent sustainability disclosures and standards. We believe more haste leads to less speed (and effectiveness) when it comes to ESG, especially against a backdrop of increasing costs and uncertainty. Given that rents of outdated buildings in markets such as Tokyo, Hong Kong and Singapore are estimated to be around a third lower than comparable newer buildings, there is potential financial upside for investors in modernising assets. However, we need to be discerning around the differences between repurposing, retrofitting and refurbishment, which are frequently bandied together as the same. There is a limit to how much ESG-related performance uplifts can be extracted from simple refurbishment efforts. Construction costs may stay elevated in the near term, which mean that the financial benefits of retrofitting may not be obvious. To that end, investors should not cut corners and must be wary of embarking on asset enhancement initiatives that are superficial at best, all in the name of ESG. In Tokyo, for example, many old offices that are located far from transport nodes have seen a sharper fall in occupancy and rents. Even if an investor were to upgrade older buildings in poorly located precincts in Tokyo, the exercise may prove to be futile.

It is presumptuous to assume that we can simply identify an investment opportunity at the bottom of its valuation cycle. For instance, prime retail values have declined by more than a third in some APAC cities. This has certainly attracted interest from investors looking to buy the bottom, with the view that the intrinsic value of retail will be realized gradually. Even with international borders re-opening, anecdotal evidence suggests that rebound tourism is focused on services instead of goods. In markets such as Australia, city retail is challenging given that it will take time for office workers to stream back into the CBD. In fact, the face of CBD retail may have changed permanently should hybrid working increase in prevalence. As such, the much-touted contrarian play in distress assets demands a careful assessment of the long-term fundamentals.

The White Rabbit represents a bastion of reliability amidst the chaos

It was the White Rabbit returning, splendidly dressed, with a pair of white kid gloves....

Even as the proceedings in Wonderland became curiously strange and unpredictable, the White Rabbit was the rare epitome of steadfastness. Along the same line, we believe there are opportunities in APAC that share the same traits as the White Rabbit.

We are convinced a stable income return profile makes Australian commercial real-estate debt attractive in a period of rising rates and a heightened risk aversion. Unlike most other developed economies, real-estate lending in Australia is predominantly provided by banks.

Accordingly, the ability of borrowers to access debt funding relies to a large extent on the credit availability from the major banks. This contrasts with the major markets of North America and Europe where the non-bank debt markets have traditionally been large and liquid. Increased regulatory oversight and a reduction in risk appetite by commercial banks has created a significant opportunity for non-bank lenders in Australia. This supply-demand differential allows real-estate lending to achieve higher income returns for investors while taking on less property risk, given the equity cushion demanded by lenders.

The credentials of the Japan multifamily sector are well documented. Population growth and changing lifestyle priorities have reinforced the already strong propensity to rent amongst urbanites. While the national population of Japan is declining, positive net internal migration has been a reliable driving force of population growth in key cities. Greater Tokyo was home to approximately 37 million residents as of 2021, which makes it the largest metropolitan area in the world. Yet, as of 2018, more than 50% of dwellings in the Tokyo 23-wards were rented. On average, Greater Tokyo accounts for more than 70% of overall multifamily transaction volumes in Japan each year. The pandemic has reinforced the defensive attributes of the Japan multifamily sector, as we saw rents and occupancy hold up relatively well.

In the Year of the Rabbit, we expect essential retail formats to continue to outperform as real wages stay subdued and consumers cut back on discretionary purchases. Specifically, we think there is a sweet spot in Australian neighbourhood retail formats, weighted towards the non-discretionary trade mix, located close to population centres. The location attributes of neighbourhood retail also lend themselves superbly to alternative uses such as last-mile logistics and click-and-collect points.

Conclusion

The Year of the Rabbit need not necessarily be a 'hare-raising' one (all pun intended). Even as risks are mounting, APAC offers diversification and opportunities.

Our fundamental outlook for Asia Pacific real estate is underpinned by a risk-off stance in the Year of the Rabbit. We are of the view that investment underwriting in Asia Pacific real estate should focus on the resilience of cash flows and income, further underscored by secular drivers of key property investment themes.

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