THINK: Asia Pacific
More than ever, investing in resilient cities is key

Introduction

Even as we continue to espouse the positive pass through of improving economic conditions on regional real estate markets in the near term, we are at the same time cognisant of where we are in the property cycle. We have continued to highlight the risks that late-stage investing has on a blended portfolio's total returns over the medium to long term (see our previous report 'THINK Asia Pacific: 2018 outlook', dated 15 January 2018). The stock market turmoil at the start of February 2018 has conveyed an opportune warning to institutional real estate investors. Despite supportive economic growth, capital market volatility will heighten throughout 2018 (as global central bank's monetary policy diverge and/or tighten) thereby posing significant risks to stretched valuations in some property markets not backed by sound fundamentals. The days of 'easy money' investing, driven by globally loose monetary conditions, are probably over.

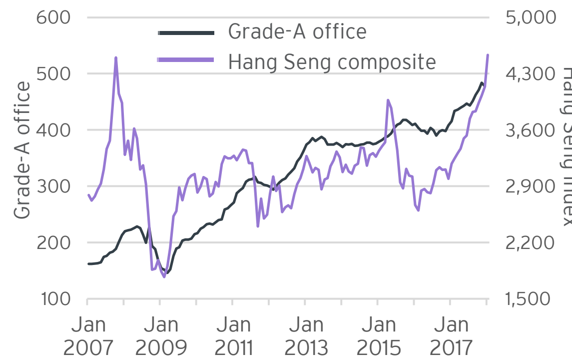
To the extent that real estate is less liquid and pricing is more scattered, vis-a-vis equities, it carries across an even more nuanced message. Whether or not the recent stock market correction belies a longer-term weakness in investment sentiment, investors should consider taking this window of opportunity to refresh their portfolio whilst staying firmly focused on building out a balanced, diversified and strong-performing portfolio over the long term. This entails having a well-laid out and clearly defined cities strategy that will provide ongoing value creation that should ride out short-term cyclical volatilities. That is, investing into cities and sectors that are underpinned by positive secular economic and structural drivers, led by proactive policy intervention and backed by pronounced megatrends. For example, urbanisation, the rise of the middle class or ageing and declining population growth. Our selection of 17 key Asia Pacific cities, through a proprietary ranking framework, underlines this thought process and will continue to frame our investment philosophy.

Hold your nerve...

We continue to maintain our view that pricing across most regional real estate markets should stay well-supported at current elevated levels in the near term. Over the past decade since the Global Financial Crisis (GFC), real estate cap rates have continually compressed, reflecting a number of key drivers, such as low interest rates and the search for yield, steadily improving economic outlook and better property fundamentals overall. We believe these drivers remain broadly supportive today.

Near-term economic momentum is strengthening. This reflects sturdy internal demand and improving global growth. Unless a sharp and prolonged downturn in global stocks persist - which will inevitably impact on corporate balance sheet, household wealth and demand and consequently depress on real economic activity - the outlook for regional properties will stay relatively robust. Hong Kong's experience, entering the 2008 GFC in a healthy shape, suggests only a momentary correction and v-shape recovery in real asset values in the event of an externally-triggered downturn (Fig.1). A similar case can be made for Singapore, Australia and South Korea a decade ago.

Fig.1: Hong Kong – fundamentals rule



Source: CEIC, 2018

Real estate fundamentals also remain broadly supportive. Across many Asia Pacific markets, occupier demand has continued to strengthen as business and consumer conditions pick up over the past few years. Positive net absorption alongside steadily increasing (and not wholly excessive) supply has, in turn, led occupancy and rents higher. Such favourable fundamental conditions can be found in the Seoul, Brisbane, Sydney, Melbourne and Singapore office markets. For example, in Singapore, where much of the forecasted development has already been front-loaded, subdued supply risks is likely to continue to drive rents higher.

Financing and capital market conditions also remain broadly supportive still. Most regional central banks are likely to hold rates at, or near to, historical lows for some time to come (especially if the stock market volatility persists) due to disinflationary pressure and still below-trend growth. Even in markets where regulators have tightened lending conditions, robust domestic liquidity and/or alternative lending channels will keep the credit tap open. A good example is in Australia, where private commercial debt lending should continue to supplement the funding gap from tightening lending standards imposed by the Australian Prudential Regulation Authority (APRA). In China, robust domestic banking system liquidity, and strong real estate allocation by domestic insurance companies, should help mitigate the potentially rising rates environment. Capital market sentiment remains strong, with unutilised equity/debt allocations providing a floor for pricing adjustments.

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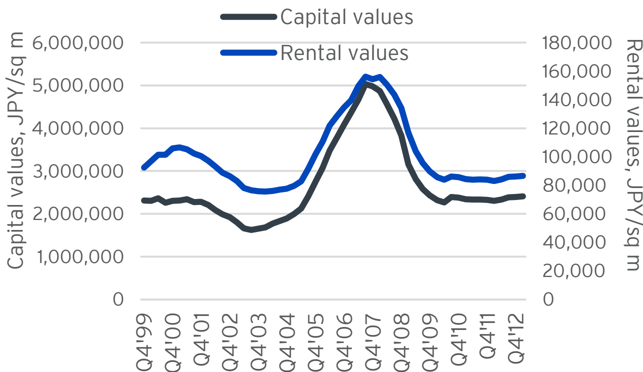
Gearing is contained.
Unlike before the GFC in 2008, where loan-to-value in many markets reached as high as 90%, a much more comfortable level of gearing since will also help contain potential distress sales in the event of an ongoing contagion led by stock market declines. In Japan, gearing averages about 50-65% for commercial properties, which should provide a good buffer to covenants. In contrast, a loan-to-value of 90% and the drying up of CMBS lending during the height of the GFC led to rapid price declines and widespread distress (Fig.2).

Fig.2: Tokyo office serves good warning

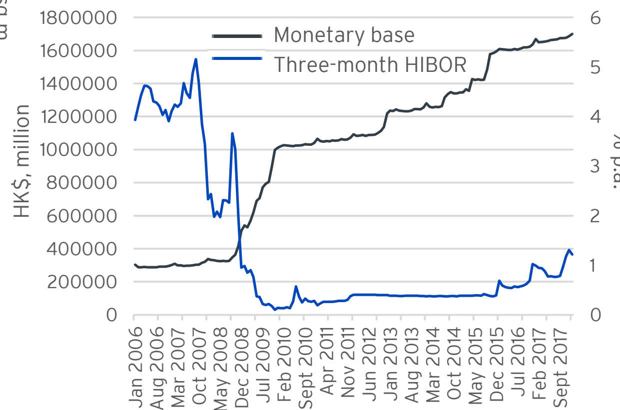


Source: JLL, 2018

...stay vigilant and focus on resilience

As much as the confluence of factors highlighted above continues to point to supportive market fundamentals, investors should not be complacent about the risks of further spikes in yields and also capital flow volatilities on cap rates movements. While we do not expect a repeat of the GFC, when the global financial system came to a standstill, we are conscious that capital volatility will follow rate increases, which may impact on investment appetite and sentiment. In Hong Kong's case, due to the dollar peg and the HK$ serving as a proxy funding currency for the greenback, the banking system monetary base has more than tripled since 2008. That, alongside a very liquid interbank market, has pushed up asset values. This trend will continue to reverse, as the Fed raises rates sequentially over the coming years. In Singapore's case, the three-month SIBOR has already jumped close to 100bps from the bottom in 2015 and will likely continue to rise as liquidity conditions tighten. In truth, elevated pricing coupled with rising financing costs will continue to suppress on risk-adjusted returns and the overall near-term attractiveness of the real estate market. We believe investors need to be tactically nimble under the current market landscape, and more than ever, consider to look past cycles into resilient cities and sectors that will provide long-term uplift to income and values.

Fig.3: Hong Kong – rising rates to come



Source: CEIC, 2018

Fig.4: Singapore - SIBOR edging higher

Source: CEIC, 2018

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