The ABCs of Asia Pacific real estate

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In a recent meeting that I attended, a sophisticated investor lamented the fact that real estate has increasingly become commoditised and institutionalised as a financial product. In his view, the typical investor in recent times has begun to allow short-term financial dynamics to affect long-term investment decisions and outcomes, and that fundamentally alters the capacity to ride through cycles and generate favourable risk-adjusted returns. Especially in mature markets where the proliferation of financial engineering and the chase for yield have led to kaleidoscopic strategies, he added that most investors seem to have forgotten the basic purpose and drivers of real estate in any economy. Post meeting, as I bade farewell to this investor who gave us much food for thought, there was a nagging sense of relevance to reflect on the approach towards real estate investing. With core yields in most Asia Pacific (APAC) markets at or below historical lows, investors are increasingly basing their investment decisions on the absolute achievable returns. The chase for yield inadvertently distorts the perceived rationality in risk-adjusted returns and capital starts to move up the risk spectrum.

In the last two years, we have advocated that the period of rapid yield compression is coming to an end as central banks start to withdraw liquidity. In many markets income has or will soon become the main driver of returns, and it is almost certain that real estate will offer lower returns over the next cycle than it has in the last ten years. It is therefore imperative that investors understand and appreciate how real estate derives its value from end-user demand instead of pinning their hopes on the capital growth story.

Investors need to first have an unbiased grasp of the actors in the economy, as real estate is intricately linked to how global and regional economies perform, and that ultimately influences the second order demand and supply dynamics of real estate. Only by going back to the basics can we truly harness the underlying drivers and adapt our strategies to take advantage of both tactical and strategic opportunities.

Essentially, the building blocks of real estate investing in APAC can be as simple as "ABC".

ABCs OF THE REAL ECONOMY - IT'S THE ECONOMY, STUPID.

A is for Asia, now

As we walk down memory lane, the scenes of the Asian Financial Crisis in 1997 loom large. The financial contagion back then spread like wildfire as an immediate and sharp pullback in capital flows wreaked havoc on Asian economies and regional property markets.

Much has changed since 1997. The Asia of today is the world economy's undisputed growth leader, supported by sound(er) financial systems, deeper banking sectors and a greater sense of prudence. Are we in better shape than we were two decades ago? Broadly speaking, it is a compelling yes, as Asian economies are now far less reliant on foreign capital inflows. Most Asian economies now run current account surpluses, and many more have abandoned fixed exchange rates in favour of floating rate regimes, effectively reducing the exposure to foreign currency risk. If any, the one key concern that could derail economies and property markets across the region is debt. Overall debt levels in Asia are generally higher than they were in 1997, and it is not just in China. If monetary policies tighten excessively, that may further dampen domestic demand, and in an extreme scenario, lead to short-term wealth and financial shocks that could have severe consequences for APAC countries with elevated external debt, or high and rising private sector leverage.

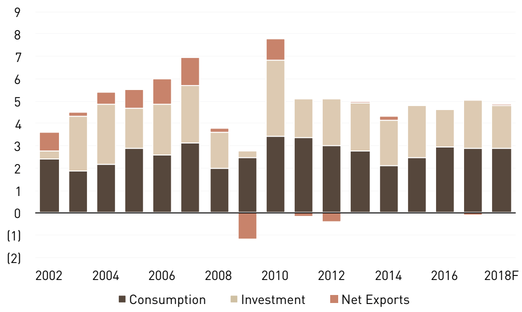
We maintain our growth outlook for APAC in 2018 at approximately 6.5%. Notably, APAC is expected to contribute to more than half of total global growth in the next two years. Most of APAC is also well placed to sustain expansionary fiscal policies over the next couple of years, as governments ramp up on infrastructure spending and social programs that will foster long-term inclusive growth, which all feed into the economy and ultimately demand for real estate.

B is for Business

Most real estate practitioners tend to view businesses solely from the perspective of commercial real estate, associating corporates merely as users of office, industrial or retail space. Fact is, the impact of the private business sector extends beyond just that. A key contributor to economic growth is private sector investment and that drives corporate expansion, not just in the form of commercial property demand, but also through ancillary services and job creation. The linkages are not apparent but the spillover benefits of corporate investment manifest themselves through greater domestic demand, stronger residential markets and even enhancing wealth effects via the stock market, which is a feedback loop that further reinforces business optimism.

As at end of 2017, most Asian economies recorded remarkably stronger Purchasing Managers' Index readings compared to the same period in 2016. Business outlook survey results also hit new highs in the last two years. For example, buoyant corporate profits and strong business optimism in Japan have bolstered the confidence of Japanese corporates, with new machinery orders in 2017 rising to the highest level in a decade, a clear signal of the beginning of an elusive capex cycle which is expected to further close the output gap in the next few years. How does this affect strategy? Understanding the tailwinds from the recent export upcycle may lead to either a knee-jerk tactical move into industrial property, or it could also mean a long-term strategic investment into core multifamily assets as companies start to ramp up capital expenditure and hiring, and the resultant rising wages feed into structural demand for rental housing.

Figure 1. Asia – GDP contribution (percentage points)



Source: Oxford Economics, CEIC, UBS Asset Management, February 2018

C is for Consumer

Much has been said about the Asian consumer, specifically with a halo over the Chinese and the emerging middle class in most of developing Asia. The scenes of Asian tourists and domestic shoppers thronging malls and high streets throughout the region is a clear sign of the propensity to consume in this part of the world. Most of Asia, with the exception of perhaps China, report favourable household consumption shares of GDP in excess of 50%. These may seem high, but relative to the likes of developed economies such as the United States or the United Kingdom where the same measure is easily above 60%, consumption in Asia has significant catching up to do before even being considered as a growth locomotive. And linked to the earlier section on businesses, households need to see steady employment and wage growth in order for domestic demand to rise to the occasion. If the recent global economic recovery is to have legs, the consumer has to step up and start doing some heavy lifting.

China continues to transit into a services-led and consumption driven economy, and that has created massive opportunities in the area of retail and modern logistics real estate. However, investors need to realistically assess the implications of a possible slowdown in productivity or fallout from corporate indebtedness in China before placing their bets on the Chinese consumer spending its way to economic prosperity. In Australia, improved labour market conditions should help boost consumer sentiment in the medium-term as policy makers attempt to fend off the risks from dwindling domestic consumption. Furthermore, strong employment prospects will allow the Reserve Bank of Australia to hold its ground on interest rates amid mounting concerns about Australia's economic growth. Japan needs to resolve the conundrum of a tight labour market which is somewhat not feeding into wage growth. The unemployment rate is at a multi-year low due to strong corporate sentiment, and the jobs-to-applicants ratio hit a 43-year high in 2017, which puzzling enough have not translated into noticeable wage inflation. While Japan's labour market reforms are progressing, such as encouraging women and the elderly back into the labour market, the incremental workforce is mainly made up of contract workers whose wages are at least a third lower than full-time employees.

To that end, consumers and businesses have a 'chicken and egg' relationship, which is self-reinforcing but could also end up caustic if one side of the equation falls off. Consumers are the lifelines of businesses, and the converse holds true. Participating in the consumption story of Asia needs to be accompanied by a clear view of corporate sector dynamics, without which we believe investors are not adequately underwriting the risks in their property investments.

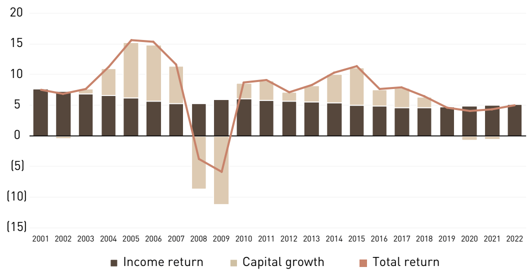
ABCs OF REAL ESTATE STRATEGY – IT'S NOT ROCKET SCIENCE

A is for Active Management

Investors should not find excuses for ignoring occupier performance or neglecting the active management of the undervalued aspects of real estate. In the last cycle, investors which had deployed in APAC were generally able to generate substantial returns just from a downward shift in yields. This will not be the case going forward. Instead of identifying mispriced assets and seeking to generate returns from arbitrage, investors must now focus on the active management of the undervalued aspects of their properties. This can be done through regular asset enhancement, strategic repositioning, re-tenanting, and a variety of other asset-specific initiatives – the end game is to grow every single income component of the property, by increasing rents or increasing rentable space, and thus boosting intrinsic value.

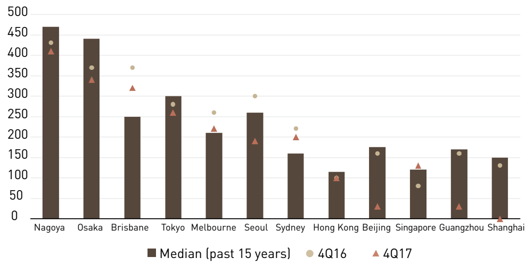
In an environment of higher interest rates, investors should turn their attention to APAC markets where occupier conditions are improving relative to recent averages. For example, expected returns are set to be much lower for new capital buying into the core Sydney, Tokyo or Hong Kong office sectors. This also implies that in a supply constrained market such as Sydney or Hong Kong, value creation becomes even more essential, even for existing asset owners. In these markets, active asset management strategies could prove to be very rewarding in the medium term, particularly for core investors.

Figure 2. Breakdown of global all property total returns (precentage, unleveraged, local currency, p.a.)



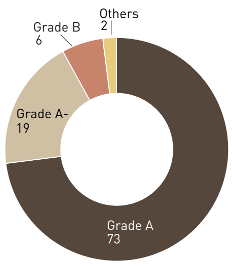
Note: All forecast expectations refer to unleveraged investments in local currency terms. Actual returns may vary materially from forecast returns. Shaded area indicates forecast data. 2017 refers to estimate. Global figures refer to neutral global allocation. Source: MSCI, NCREIF, UBS Asset Manage-

Figure 3. Property yield spread (prime office, basis points)



Source: Datastream, PMA, RCA, UBS Asset Management, February 2018

Figure 4. Tokyo office supply 2018-2020 (percentage)



Source: UBS Asset Management, February 2018

B is for Buy-and-Fix

On paper, this may seem like a no-brainer approach to real estate, but in practice many investors have overlooked this strategy over the last decade. In markets such as Japan and Australia, yield spreads relative to long-term bond yields remain relatively attractive, theoretically extending the runway for further cap rate compression in the next few years. We however believe the marginal capital value growth story is reaching a limit, and investors should, in practice, start to look at value creation even in these 'spread-positive' markets.

In the tier one cities of China, such as Shanghai and Beijing, the inward shift of domestic capital has resulted in yields that are at historical lows, and spreads that are even negative in extreme cases. Foreign investors looking to partake in the China growth story are now effectively priced out of the core real estate space. However, if one looks at the age profile of well-located commercial assets in Shanghai, more than half of these assets were constructed at least twenty years ago when China was embarking on the opening up of its economy. As another case in point, we look at the Tokyo office market where core pricing is similarly tight, driven by attractive yield spreads and intense competition by domestic REIT buying. We estimate that approximately 80% of small and midsized office buildings in Tokyo were built more than twenty years ago. With the upcoming supply avalanche focused on the Class A office segment, newly built Class B office buildings are relatively low in supply. With more than 90% of office tenants in Tokyo being small and medium companies with less than 30 employees, the demand-supply favours the value-add of existing class B office assets. Is there any scope for investors to 'buy-and-fix', and maybe potentially create core assets out of secondary ones in these examples? The answer is a definitive yes. These strategies in Japan and China are not passive ones, and they are not cyclical in nature; however they require astute investors with a clear aptitude and capability in identifying such gaps, and executing on these 'buy-and-fix' opportunities.

C is for Core

Excessive optimism coupled with a herd effect may make for decent short-term outcomes, but investing on fundamentals is still the key to long-term outperformance. For example, looking past cyclical factors, we are cognisant that the short-term supply pressures in the Tokyo prime office sector will not diminish the longer-term resilience of Tokyo due to its financial center status and investment liquidity, amongst others.

With fundamentals taking over as the key driver of performance, Asia's growth premium is likely to underpin the region's outperformance in core real estate markets, but that will only materialise over the longer term. Bearing in mind that real estate ultimately derives its underlying value from end user demand, megatrends such as urbanisation, demographic deficit and digitalisation will manifest in the longer-term through core real estate. For instance, the combination of denser cities in Asia, labour shortages due to ageing workforces and the pervasiveness of electronic commerce, may mean that the traditional concept of large distribution warehouses will be made obsolete. In their place, small infill urban logistics centres could be the prevalent mode of core logistics real estate. Already, we see this happening in some parts of China and Japan. As another illustration, urban renewal and infrastructure development in Asia will create new growth centres where new core real estate may be located. We see that the CBDs of Sydney and Melbourne are expanding with the metro lines being built, and the urban rejuvenation in Singapore and Hong Kong is creating 'second CBDs' in these markets. These themes take a longer time to gain traction, and investors with a more patient investment horizon are better placed to ride through cycles and even enter before secular trends are priced in by the general market.

Epilogue – Back to basics

We advocate that investors continue to take an evergreen approach towards active income creation, identifying real estate opportunities underpinned by structural trends, and taking a long term view of prospects within APAC.

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