SAVILLS INVESTMENT MANAGEMENT

When Cassandra meets Pollyanna

Bridging views in APAC real estate

A stage play in three acts by Shaowei Toh, Head of Research & Strategy Asia-Pacific.

September 2023

Cassandra and Pollyanna on APAC prospects

CASSANDRA:

Origins in Greek mythology – A princess of Troy granted the gift of prophecy, but no one would believe her visions. In contemporary usage, a "Cassandra" is used to refer to someone who sees the glass as half-empty, and has an ever pessimistic outlook.

POLLYANNA:

Pollyanna is a character from a 1913 namesake novel written by Eleanor H. Porter. She is a young girl who remains extraordinarily optimistic and upbeat despite hardships. In modern usage, a “Pollyanna” refers to someone who always views the glass as half-full, and sees the good in everything.

Act 1: The banter

NARRATOR

The tasteful café nestled in the business district is rather discreet with a handful of patrons. The mellow light from old-world wall lamps plays gently on the rich, mahogany tables, a majority of which are unoccupied.

Amidst the whispering cacophony of conversations, we overhear a debate between two archetypal figures: Cassandra and Pollyanna.

Cassandra, with a hint of concern etched on her face, seems poised on the brink of a tempest. Conversely, Pollyanna, personifying relentless positivity, exudes energy that can turn even the gloomiest of scenarios into opportunity sets.

CASSANDRA

Looking around

Notice the quiet? It’s eerily similar to Asia’s commercial real estate scene right now. Full of uncertainty and investor trepidation.

POLLYANNA

Cheerfully

I see these same spaces, Cassandra. Perhaps, these empty spaces are also opportunities waiting for us to act on.

CASSANDRA

Opportunities? Are we observing the same landscape? Property markets in Asia are looking at a ‘higher for longer’ era of uncertainties.
Can you deny the impact of digital disruptions, Polly? Technology shifts have set in motion changes that will alter the fundamental demand for real estate. Retail faces an existential threat from e-commerce, and that is not even a new issue. Many companies have adapted to a ‘work from home’ hybrid model, which questions the relevance of physical offices. I could go on.

POLLYANNA

Well, Asia Pacific real estate has demonstrated resilience in the face of recent economic cycles. We have seen some repricing happen in selective segments within APAC, for sure, but rent growth is generally robust. That has helped hive off a widespread re-rating of real estate across the region.
You are partly right. Remote working is prevalent, but it is not a universal norm. The cultural emphasis on face-to-face interactions in many Asian cultures will prevent the total hollowing out of offices. We also cannot use a broad-brush approach when looking at retail.
Look, technology is the genesis of new asset types such as life science offices, smart buildings, healthcare facilities and data centres.
So, disruption does bring with it creative innovation.

CASSANDRA

Frowning still

Ironically, doesn’t the overall macroeconomic divergence suggest that Asia’s property returns might be comparatively lower in the near term?

We are seeing a value reset happening in Europe and the US today, which means investors should find these markets a better vintage point for investing. Asia may, very soon, not find favour with global investors.

POLLYANNA

Asia is a diverse region, helmed by the second and third largest economies in the world. And even within a single country, different cities perform differently. What has been really telling is the resilience of Asia real estate markets. Yes, without a major price reset, we might find that nominal property returns in most of Asia may appear relatively lower than that in Europe or the US. Some capital will indeed pivot towards these markets. We saw that happen in the post-Global Financial Crisis (GFC) years. But for many investors, the quality of returns is now as important as the magnitude. Asia Pacific real estate offers diversification for core investors, and income security has proven to be solid across events such as COVID-19 and the GFC. The risk-adjusted returns may not turn out to be inferior!

CASSANDRA

Her fingers tracing the rim of her glass

Polly, as we've seen, when market uncertainty increases, the natural response of domestic and international banks is to reduce risk. Their capital is often channelled towards underwriting lower loan-to-value ratios, and high-quality assets and sponsors.

POLLYANNA

Leaning forward, with a nod

That's right, Cass. And in such scenarios, traditional lenders are likely to prioritize refinancing existing loans nearing maturity. Existing non-bank lenders, on the other hand, focus on land and build-to-sell assets. This approach, however, leaves a gap in the lending market.

CASSANDRA

Raises an eyebrow

A financing gap, you say?

POLLYANNA

(Eyes dancing with excitement)

Precisely! There exists an underserved space where non-bank lenders can still find good opportunities. For instance, institutional private credit can finance transitional and yet-to be stabilised assets with higher LTVs. Even amidst the financial quagmire, some see potential where others see peril. If investors are not confident yet about the equity side of real estate investing, they can still get exposure via private real estate debt. Debt investment strategies can focus on first mortgage and capital protection.

CASSANDRA

Thoughtfully thinking of a counter-argument

Yes, but geopolitical risks have added to the complexities. Moreover, the 'demographic time bomb' of aging populations in many Asian countries poses a significant challenge. There will be little demand for real estate.

POLLYANNA

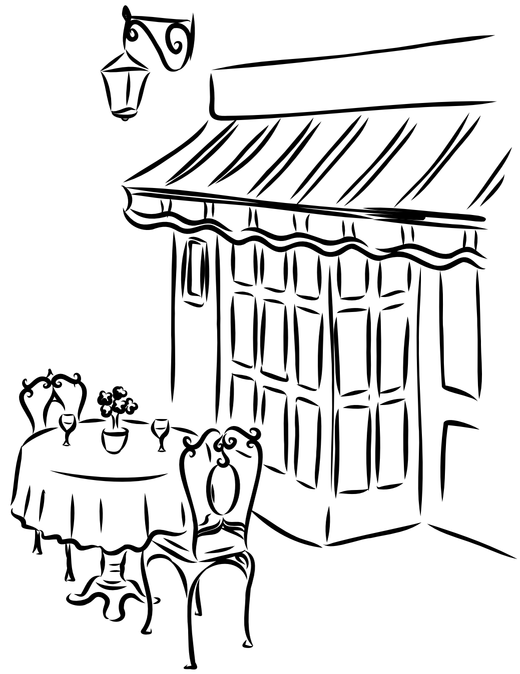
Nods, smiling serenely

Indeed, the challenges are real. The trends towards regionalization and near-shoring can act as a counterbalance to geopolitical risks in the long term. And that in turn creates domestic demand for real estate such as logistics.
Worsening demographics is not just an Asia problem. It is happening globally. As lifestyle needs change, there will be a demand for other types of commercial spaces. Let's not forget urbanization and centralization. Populations in key cities such as Tokyo, Seoul and Sydney continue to grow due to this movement, and that's essential in the commercial real estate narrative

CASSANDRA

Unconvinced look

We face a complex situation. The regulatory and technical obsolescence of buildings complicates things in commercial real estate even as demand is waning. Asia is already behind Europe in terms of sustainability standards in the built environment.
But when viewed through the lens of ESG (Environmental, Social, and Governance), it's clear that outmoded buildings fall short in sustainable and ethical operational practices. This is more pronounced after the pandemic. Stranded assets are worth next to nothing tomorrow.



POLLYANNA

With a twinkle in her eyes

Instead of seeing a problem, I see an opportunity to upgrade selective ageing structures into green, sustainable spaces. From an ESG standpoint, we have the chance now to create commercial real estate that is not just functional, but also environmentally conscious and future-proof. It is a canvas to redefine the conventional and infuse it with sustainability. From the financial standpoint, we can also extract the 'green premium' on high quality ESG-relevant commercial space.
Just imagine the transformation - Energy-guzzling concrete behemoths metamorphosing into green, eco-friendly havens! The possibility is not only thrilling but also signals a promising future for real estate in Asia.

(The lights dim...........)

NARRATOR

This stimulating dialogue unfolds like a dance, each step highlighting the multifaceted landscape of Asia's commercial real estate amidst structural shifts.
The divergent perspectives blend together to form a contrasting and rich tapestry of caution, resilience, and latent potential.

Act 2:
The narrator's views

We are living in unique times. Throughout the year, we have had conversations peppered with both positive and negative assessments on where global property markets are headed. For every Cassandra, there is a Pollyanna.

The fact is, regional property markets never move in absolute parallel. What transpires in Europe may not be a harbinger of developments in the Asia Pacific region. The converse is true.

In summarizing the dialogue between Cassandra and Pollyanna, we highlight some strategic views.

DEMOGRAPHICS IS NOT ALWAYS DESTINY: JAPAN MULTIFAMILY & AUSTRALIA BUILD-TO-RENT (BTR)

Cassandra raised a valid point on the demographic timebomb that many countries have to deal with. The implications are multi-faceted. As the working population shrinks, office usage naturally contracts, which is not ideal for the office sector. There is also a spill over effect on consumption, which directly deals a blow to the retail sector. Corporates may have to grapple with lower profits that manifests in weaker demand for commercial real estate, including logistics and offices. And that vicious loop continues. On the residential front, demand for housing will fall away, which is bad news for multifamily operators.

In Asia, Japan gets the bad rap for its demographic woes. Japan's dependency ratio stands at around 71%, which is hardly encouraging from the perspective of investors. While the nation is experiencing an overall decline in population, key urban centers are witnessing positive net internal migration, propelling population growth in these areas. What we observe on the national level is not the same from the regional and city point of view. According to the Statistics Bureau of Japan, the net inflow of people into Greater Tokyo (Tokyo, Saitama, Chiba, and Kanagawa prefectures) was 99,519 residents in the full year 2022. Separately, data from PMA tells us that the total population in Tokyo 23 Wards (23W) increased by around 0.4% and 0.5% y/y in 2022 and April 2023, respectively. A closer inspection reveals that the non-Japanese population in Tokyo 23W grew by an estimated 14.0% y/y in the month ended May 2023.

> Japan's multifamily sector presents a strong and compelling investment profile.

Official data from 2018 (latest available) indicates that over 50% of dwellings within Tokyo 23W were rental units, a noteworthy observation for investors. On a broader scale, Greater Tokyo consistently contributes to more than 70% of the total multifamily transaction volumes in Japan annually. The multifamily sector's stability has been further endorsed during the pandemic, demonstrating resilience with rents and occupancy rates

holding up commendably. This resilience attests to the defensive characteristics inherent in Japan's multifamily real estate market.

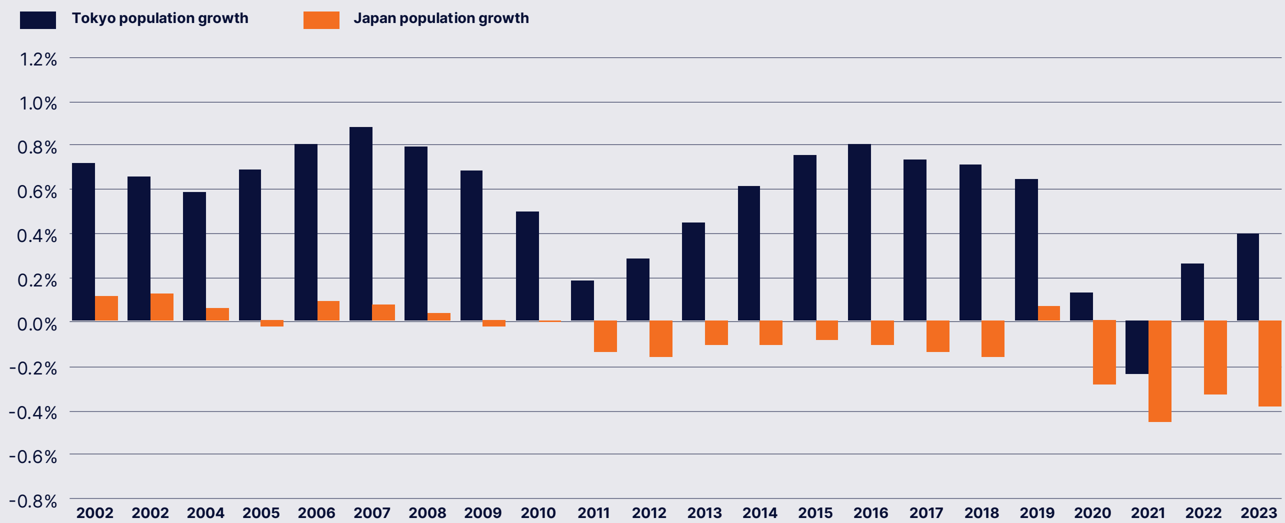
On the other end of the spectrum in Asia, we have Australia, which is the perennial poster boy for demographic strength. Australia's Centre for Population projects a roughly 10% rise in Australia's population over the coming decade to 2030, amounting to an average annual increase of 246,000 people. The imbalance in Australia's housing landscape, particularly a deficit in supply on the Eastern coast, along with escalating rental rates and an insufficient stockpile of high-quality rental options, are driving the quest for superior long-term rental solutions.

> "BTR in Australia is in its nascent stage. However, in global markets like the US, Europe, and Japan, it is a mature asset class.

In Australia, the composition of funding for institutional investments into the residential sector stands at roughly 3%, in stark contrast to the United States and Germany, where it approximates at around 35%. There's a similar narrative when we examine the proportion of the BTR sector relative to the overall residential market. In Australia, BTR constitutes a modest 0.2% of the market, significantly lesser compared to the United Kingdom's 5% and the United States' more substantial 12%.

State governments have enacted several measures, incorporating financial, regulatory, and tax incentives to encourage the private sector to devise solutions with long-term capital. Given the sector's potential for stable yields and appreciation, it's poised to become an integral part of Australia's real estate landscape.

FIGURE 1:
Population growth (% YoY)



Source: PMA (June 2023), Japan Bureau of Statistics (6 August 2023)

EMBRACING WATER COOLER MOMENTS IN THE ASIA OFFICE SECTOR

Across key office markets in Australia, we expect a widening dichotomy between high quality and average assets. The demand, occupier and valuation gaps between prime and secondary properties/locations are predicted to widen over the next few years. In the context of the rising trend towards hybrid work arrangements, 'flight to amenity has emerged as a prominent market dynamic. By that, we refer to not just quality, but also ancillary characteristics such as accessibility, convenience and lifestyle.

In the immediate future, demand is likely to remain subdued due to ongoing space rationalisation by large corporate occupiers. However, tight labour market conditions provide a baseline support for office absorption despite changes in working patterns accelerated by the pandemic. That said, this demand has been mainly concentrated in the high quality segment. According to research by JLL, pre-COVID office density in Australia was already below the global average of 13.3 sqm per person, at 11.1 sqm and 12.0 sqm per employee in Sydney and Melbourne respectively. In Germany, office density in Frankfurt and Berlin was 16.1 sqm and 18.2 sqm.

In the US, markets such as Chicago and Los Angeles have ratios above 20 sqm per employee, with even New York at 16.0 sqm. As such, the post-pandemic recalibration of office footprint in Australia will happen but not in a big way.

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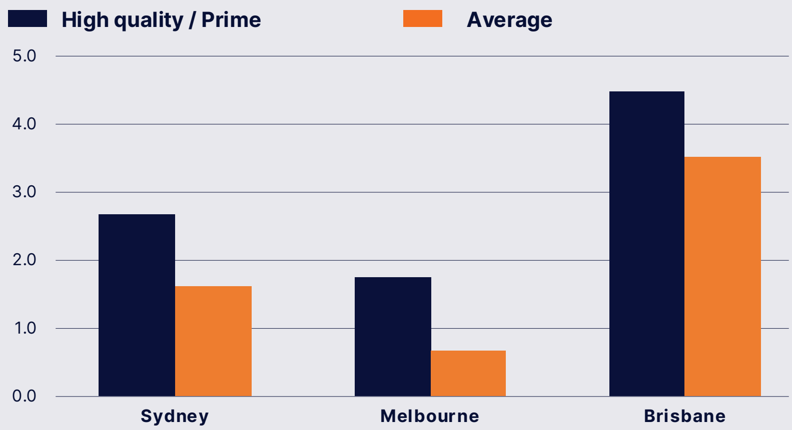
We estimate that prime office rent growth will outpace average office assets over the next five years.

Over at Seoul, occupier performance has been robust in the I office sector, which has helped to support valuations, in part. This is largely due to South Korea's effective pandemic management and a relatively low conversion to telecommuting. Before the onset

FIGURE 2:
Australia prime and average office rent growth (2023-2027, % p.a.)

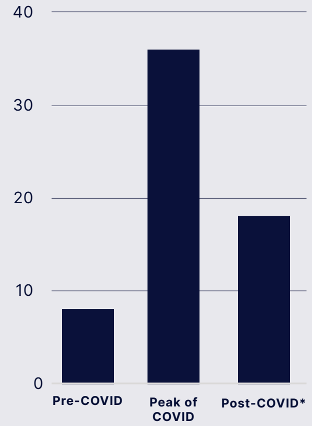


Source: PMA (April 2023)

of COVID-19, only 8% of companies in Seoul had some form of remote work arrangements. During the peak of the pandemic, that ratio went up to 36% which was still considered low because there was no full-fledged lockdown. Inferring from official surveys on employers' sentiments towards remote working, we estimate that less than 20% of firms in Seoul are supporting remote work today. The corollary of this is a high return-to-office rate, which is supporting end-user demand office space. Particularly for investors pondering the future of the office space, the Seoul office market continues to offer a long-term opportunity given the intrinsic cultural and structural differences from other global offices.

According to Savills Research, the office vacancy rate in Seoul was 1.8% in Q2 2023, and aggregate rent growth was 7.1% y/y in the same period. These numbers put the Seoul office sector as one of the best performing markets globally.

FIGURE 3:
Seoul - Implementation of telecommuting (% of firms)



Source: Statistics Korea (October 2022), Gartner (July 2021 forecast), Savills IM estimates

Effective rents in the prime office sector have increased by around 12% in 2022 alone, and we are forecasting a further blended growth of approximately 10% to 12% in the next two years. At the current level of yields, the expected rental growth will partially offset the impact of cap rate expansion on capital values.

Similar to South Korea, remote working is not entrenched into modern working patterns in Japan.

> "According to the Japan Productivity Center, Japan's telework rate peaked at 31.5% in May 2020, but has since trended down to a low of 15.5% as at July 2023.

Although companies generally do not expect office attendance to go back to 100%, many appear to have kept their leased space unchanged or only moderately reduced. One reason is that more than 80% of firms in Japan are small and medium sized operations.

Unlike the big global names, these small Japanese firms do not have the complete infrastructure and corporate culture that facilitates remote working. And notably, the robust performance in the Shibuya office submarket underscores that even sectors synonymous with flexible work, such as in tech and IT, are eager to hold onto their physical office locations.

FIGURE 4:
Japan - Implementation of telecommuting (% of firms)

Source: Japan Productivity Center (August 2023)

RETAIL: MAYHEM OR MAYBE…. AUSTRALIA ESSENTIAL RETAIL

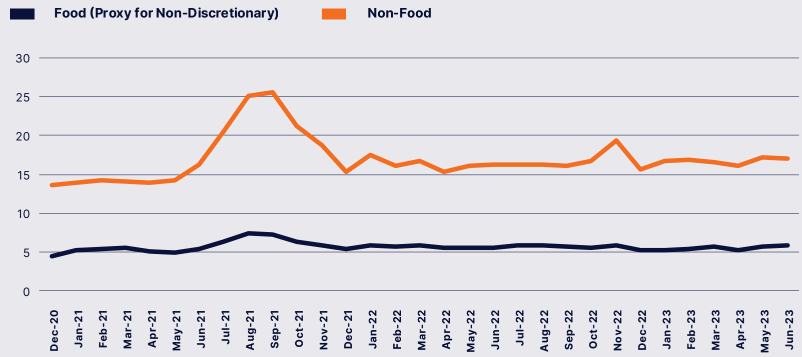
The pandemic underscored the inherent strength of essential retail, reflecting the indispensable nature of this sub-segment. In Australia, consumers lean towards the in-store physical experience when procuring essential items.

According to the Australia Bureau of Statistics (ABS), online sales made up 11.0% of total retail sales in Australia as of June 2023. What is telling is that online spending on essential items such as food related goods only made up 5.9% of total food related sales, relative to the 17.0% for general goods. According to the latest ABS Monthly Household Spending Indicator, as at May 2023, year-to-date discretionary spending was down by 0.6% y/y, compared to the 6.9% y/y rise in non-discretionary spending. This tells us essential retail continues to have a resilient position in consumer behaviour, even as e-ecommerce penetration increases post-pandemic.

Australia neighbourhood assets, bolstered by supermarkets, essential services, and medical facilities, consistently deliver stable income streams. Notably, the potential of retail rents to keep up with inflation is comparable to other commercial property sectors.

This is primarily because the sector sees regular CPI-based lease reviews, and turnover rent for key tenants serves as a safeguard against escalating costs. Looking ahead, essential retail formats are anticipated to remain strong performers, especially as real wages remain tempered.

FIGURE 5:
Australia - Online retail as percentage of total retail for Food and Non-Food categories (%)



Source: Australian Bureau of Statistics, Retail Trade, Australia June 2023

Specifically, neighbourhood retail formats, especially those geared towards essential purchases and situated near populated areas, are primed for long term capital value growth. Such locations not only serve their primary retail function but are also well-positioned for uses like last-mile logistics or click-and-collect hubs.

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> The versatility of Australia neighbourhood retail spaces becomes even more evident when considering the favorable pricing disparity between logistics and local retail.

AUSTRALIA REAL ESTATE DEBT POISED FOR GROWTH

As my colleague Mohamed Ali aptly mentioned in **his latest paper**, the growth trajectory of the Australia commercial real estate (CRE) debt market is promising, buoyed by the nation's post-Covid resurgence and a comparatively steady macroeconomic backdrop.

In Australia, the market share for non-bank CRE lenders lags behind that of the US and European counterparts, where the latter make up approximately 50% and 40% of their markets, respectively. Projected growth estimates suggest that by 2032, non-bank CRE lenders in Australia could command around 40% of the market. While this surge in the coming decade may seem substantial, it mirrors, sensibly, the growth trajectory observed in Europe. There, non-bank CRE lenders saw market share catapult from almost negligible post-GFC to about 40% by the close of 2022.

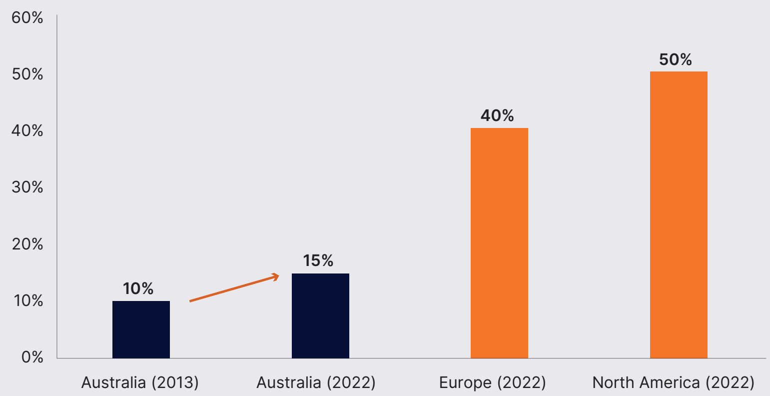
> We believe that a stable income return profile renders Australian commercial real estate debt appealing.

As Cassandra has pointed out, heightened risk aversion has led to selective loan underwriting by traditional lenders today.

This presents a good window of opportunity for investors to participate in CRE lending to the underserved segment. To add, it is not just a tactical opportunity, but also one which is structural in nature.

In contrast to some other advanced economies, the real estate lending landscape in Australia is predominantly mediated by banks. Thus, the potential for borrowers to procure debt funding is largely contingent upon the credit provisions from the major banking institutions. This is in stark contrast to markets such as North America and Europe, where non-bank debt sectors are expansive and have traditionally provided much liquidity. Augmented regulatory scrutiny, coupled with a diminishing risk appetite by commercial banks, has paved the way for substantial opportunities for non-bank real estate financiers in Australia. This imbalance between supply and demand permits real estate lending to yield superior income returns for stakeholders, all while assuming a diminished property risk, thanks to the equity buffer for lenders.

FIGURE 6:
Non-bank CRE debt exposure



Source: Estimate based on views from market participants (February 2023), Savills IM (Australia Real Estate Debt, author Mohamed Ali, July 2023)

INDUSTRIAL: UNBOXING THE FUNDAMENTALS

The foundation of the industrial sector lies in the connections between economies, consumers, and businesses. Even though there's a noticeable shift towards de-globalization, supply chains aren't vanishing entirely. Instead, they're undergoing a re-distribution. Post-pandemic, the industrial sector seems to be in a two-speed scenario, with the trade and manufacturing segment progressing at a slower pace than its e-commerce and fulfilment counterparts.

While the pandemic momentarily shifted our attention away from the trade frictions that prominently affected much of Asia in 2019, these tensions linger. In the post-pandemic world, we witness a more regional approach to supply chains, and even a return of domestic production. This trend may be more pronounced in countries with expansive domestic consumer markets, like Japan and Australia, effectively boosting domestic industrial real estate demand. In contrast, countries like Singapore and South Korea will further bank on high-value manufacturing that has significant barriers to entry.

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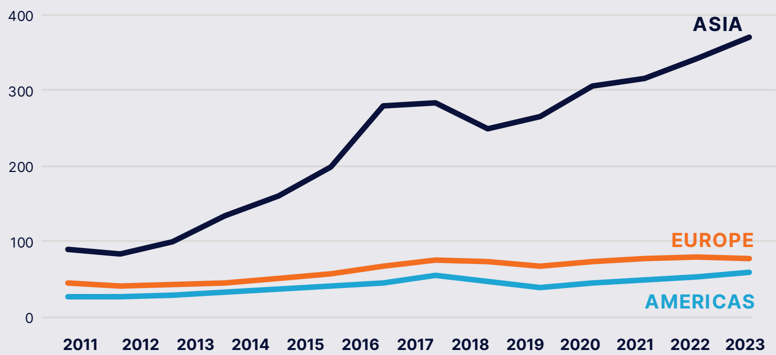
Industrial demand in APAC is underpinned by several factors.

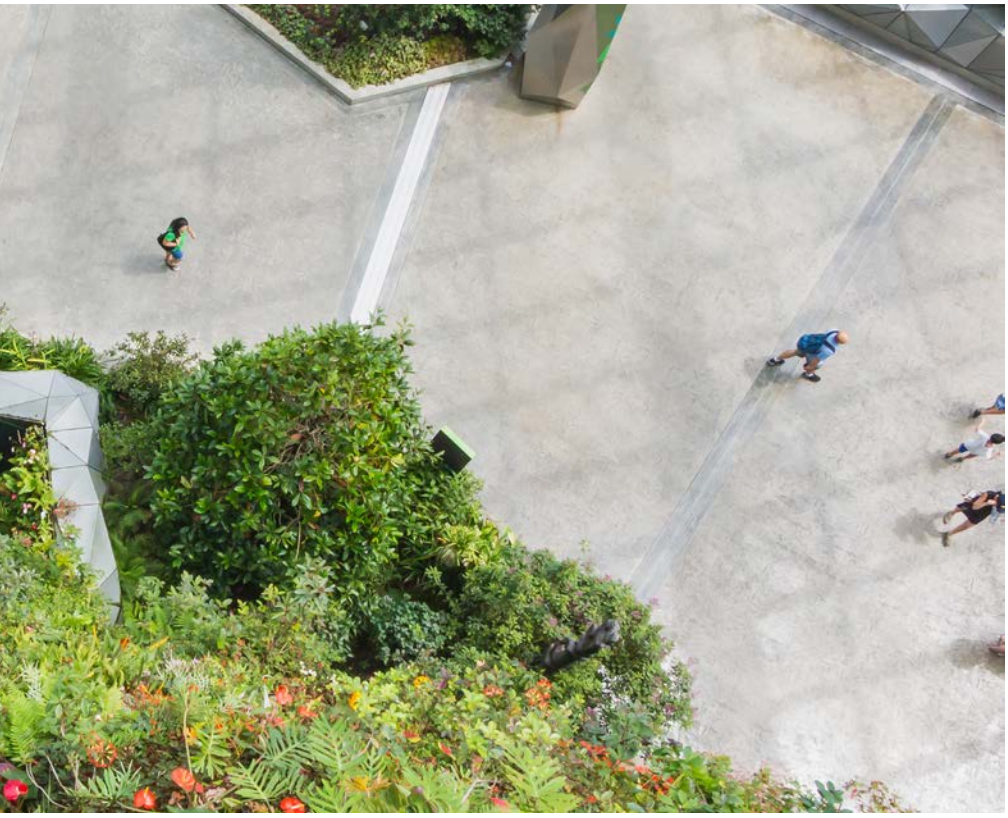
Industrial demand in APAC is underpinned by several factors. Firstly, in an effort to secure their supply chains, countries and corporations are adopting strategies like near-shoring and on-shoring. This transition has amplified the domestic and regional storage requirements.

Secondly, the meteoric ascent of e-commerce, combined with the quest for operational efficiency, has left end-users grappling to match the simultaneous expansion in warehousing needs. Thirdly, warehousing costs typically account for less than a third of an operator's total logistics costs, with transportation costs claiming another half. This cost structure implies that it's financially sensible for end-users to invest in premium, strategically situated logistics spaces, achieving transportation cost savings. Even with the e-commerce sector's low profit margins, there remains room for logistics rent growth. Finally, a noticeable reduction in the availability of industrial land throughout APAC has significantly

FIGURE 7:
Installation of industrial robots (Thousand units)



Source: IMF (January 2023); International Federation of Robotic (2021)



elevated rents and capital values for logistics assets, especially those in prime locations.

The pandemic hastened the digital transformation across the region. On one end, e-commerce spending skyrocketed, with Asia now contributing to almost 60% of global online retail sales. In countries like Japan and Australia, where online penetration has not reached the levels seen in other developed nations, there remains significant untapped potential in the logistics sector. On the other end, an ageing labour force and the competition around speed to fulfilment have resulted in greater investments into robotics. Estimates from the IMF and the International Federation of Robotics point to Asia Pacific leading the charge in the installation and use of industrial robotics. This changes the cost composition of end-users, and could reduce overall labour costs. The corollary of that is a sharper focus on securing better inland and urban locations, much of that rent expenses being offset by savings on manpower and transportation. This also implies that hardware and specifications of modern logistics facilities will have to evolve to keep up. Currently, there is still a shortage of meaningful logistics stock in the region.

We see opportunities in upgrading large parts of the current inventory in urban locations to create best in class, ESG approved, modern industrial space.

“

We see opportunities in upgrading large parts of the current inventory in urban locations to create best in class, ESG approved, modern industrial space.

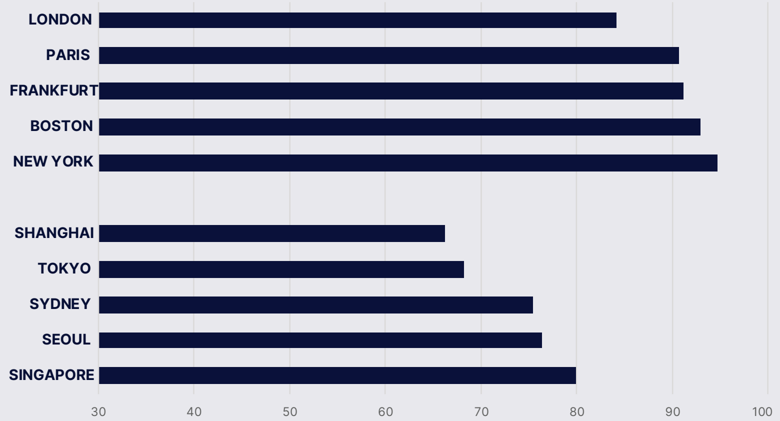
Case in point, in the context of Japanese logistics, especially in the Greater Tokyo region, only 10% of existing logistics facilities were constructed after the year 2000. Potential for resilient performance remains, especially when considering the strong tenant and investor interest compared to other sectors. The factors influencing logistics returns are gradually transitioning from cap rate tightening to rent growth, necessitating a more hands-on approach to asset and tenant oversight.

SUSTAINABILITY IN THE BUILT ENVIRONMENT IS NOT AN AFTERTHOUGHT

Cassandra may allege that sustainability is viewed loosely as an afterthought for asset owners and tenants in the APAC real estate market. This creates the impression that foreign capital often struggle to find a deep pool of investable assets that are aligned with ESG guidelines. There may also be a belief that the APAC region lacks the necessary regulatory frameworks to promote sustainability and ESG practices. These are certainly not accurate.

The EU's Sustainable Finance Disclosure Regulation (SFDR) level 2 rules were implemented at the start of 2023. While there is a notion that these SFDR provisions might be more pertinent within Europe, the fact remains that European investors often mandate strict sustainability disclosures and criteria for their APAC investments. Many countries in Asia have been progressively enhancing regulations around sustainability in the built environment. Indeed, some of the existing policies and standards are fragmented, but that is partly an outcome of the heterogenous nature of countries in the region. We have also seen a rise in green financing. Green Bonds, which are aimed at environmental projects, including sustainable real estate, have become more popular.

FIGURE 8:
Share of CBD office stock built before 2015 (%)

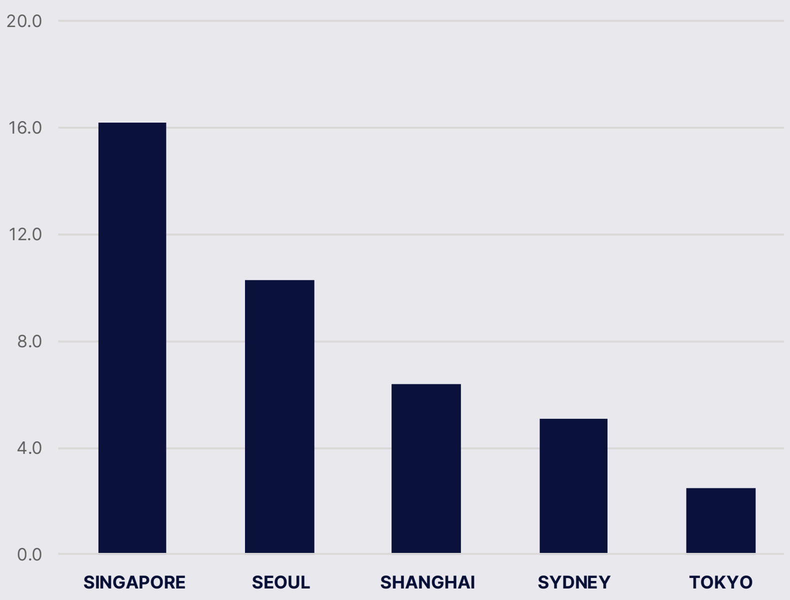


Source: JLL: The Future of the Central Business District (May 2023)

> Financial institutions in APAC are also increasingly integrating ESG factors into their lending and investment decision processes.

Similar to what we are seeing in Europe, the APAC commercial property sector is facing heightened risks of obsolescence. We estimate that more than one-third of investment properties in Asia Pacific are at least twenty years old. In the office sector, for instance, around 65% to 80% of the existing inventory was constructed before 2015. While this is still much lower than in many European and US cities, it certainly doesnt mean we can be complacent. As it is, capital expenditure as a percentage of operating income in the APAC office market had doubled from approximately 10% to 20% over a decade.

FIGURE 9:
Rental premium of offices with green certification (Selected markets, %)



Source: Savills Research (April 2022), Savills IM estimates (July 2023)

In Asia, commercial property owners and developers are no longer just reacting to regulatory pressures. They are recognizing that tenants and buyers increasingly demand sustainable features.

> Buildings with sustainable credentials can command higher rents and often have better occupancy rates.

The push for net zero means that buildings that do not have adequate ESG credentials will suffer from a "brown discount", which raises the risks of stranded assets for those that do not have other redeeming qualities such as high-demand locations.

That said, the "brown discount" is also an opportunity, since it provides scope for retrofitting, upcycling, and consequent capital growth and rentability for suitably located assets.

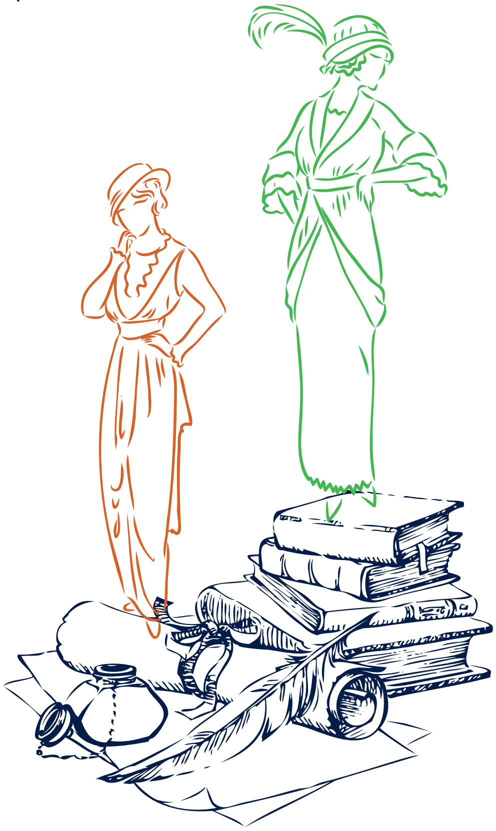
At Savills Investment Management, we are proponents of refurbishment and do not favour redevelopment, given the extensive embodied carbon footprint in the latter. In essence, repurposing existing buildings sidesteps the carbon emissions tied to demolition and reconstruction. Recognizing that by 2050, 80% of all structures globally will have been built, it becomes evident why enhancing the current inventory is a logical approach.

Act 3:
The denouement

Our view is that there is a Cassandra and a Pollyanna in each of us, or perhaps even both at the same time. However, an astute investor will always be eliciting a response through his/her investment outlook.

In a glass-half-empty scenario, the reaction could be a knee-jerk flight away from risk, or to embark on a safe-haven expedition. In a glass-half-full setting, one might expect a relentless focus on seeking out opportunities that are emerging or have proven to be resilient.

Regardless, we don't stay stagnant, and active portfolio rebalancing is key. We are convinced that the depth and diversity of APAC creates opportunities for both debt and equity investors across the risk spectrum.



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