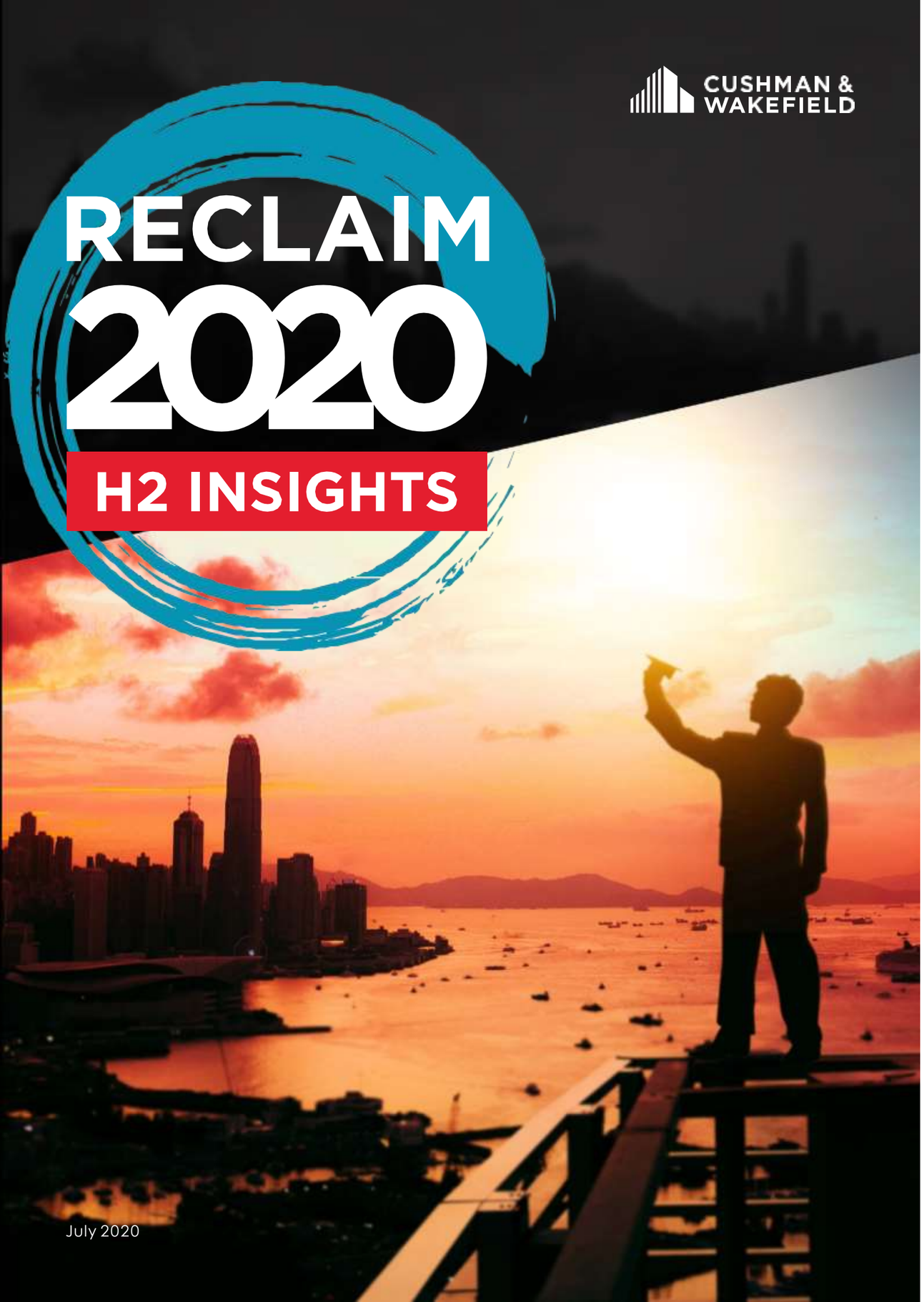
CUSHMAN & WAKEFIELD

RECLAIM 2020

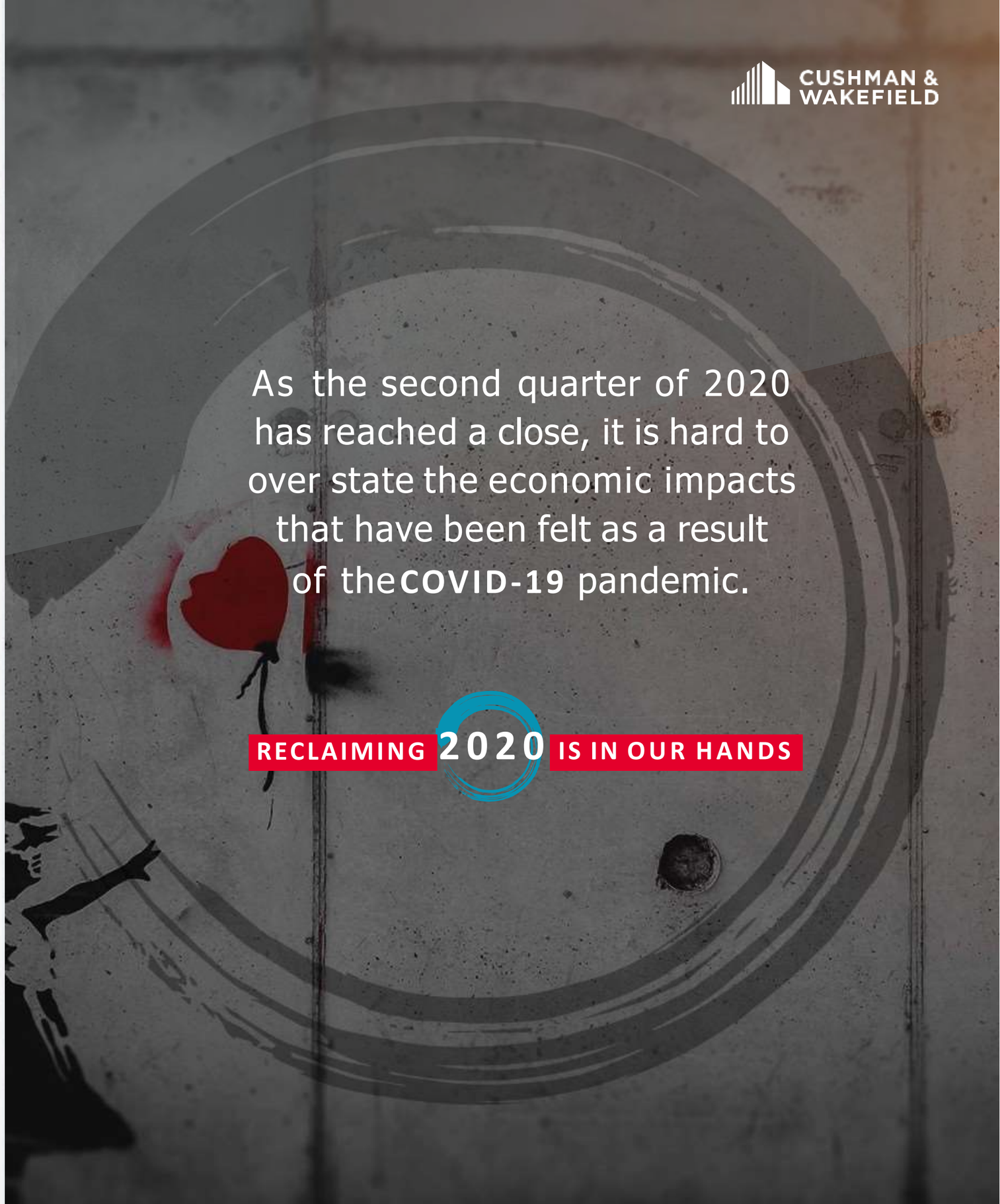
H2 INSIGHTS

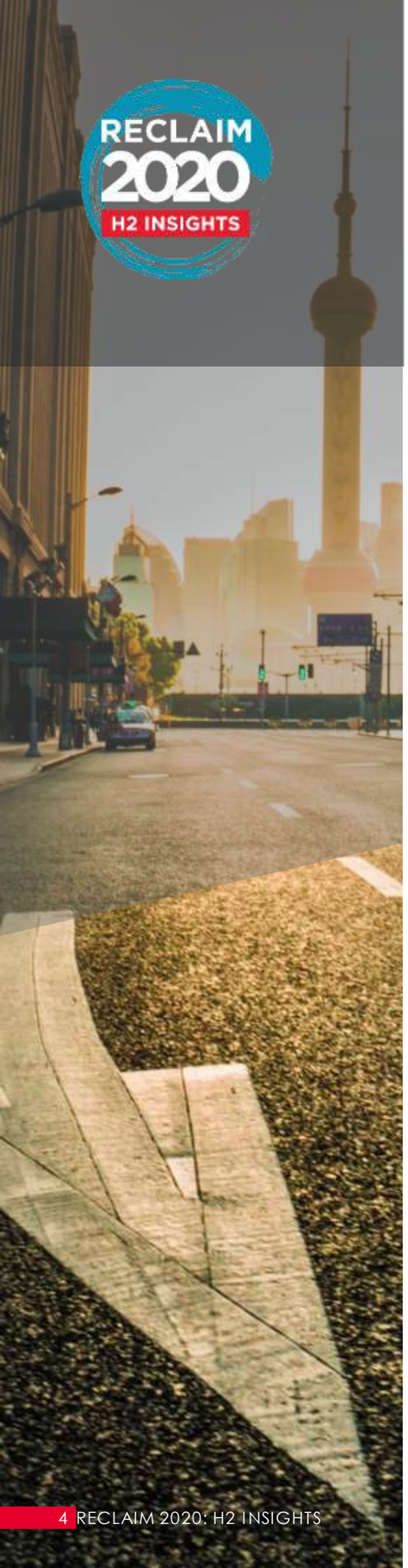


July 2020

TABLE OF CONTENTS

ECONOMIC & MARKET CONDITIONS	4
STRATEGIES TO RECLAIM 2020	6
ECONOMY	8
OFFICE MARKETS	12
INDUSTRIAL	18
CAPITAL MARKETS	20
OUTLOOK	22





ECONOMIC & MARKET CONDITIONS

ECONOMICS

- China recorded robust economic growth of 12.4% q-o-q in Q2 indicating its recovery is already underway.
- Elsewhere in the region, green shoots of economic recovery have started to sprout providing cautious hope for a rebound in Q3. However, downside risks are far from over.
- Expect athree-speed recovery in the region reflecting the relative successes in containing the virus, effect of lockdowns and size of policy response.
- Further economic momentum in Asia Pacific relies upon virus containment, especially on the global stage. Due to the relatively early emergence from the lockdowns, the region is well-placed to capitalise on this growth when it occurs.

OFFICE OCCUPIER MARKET

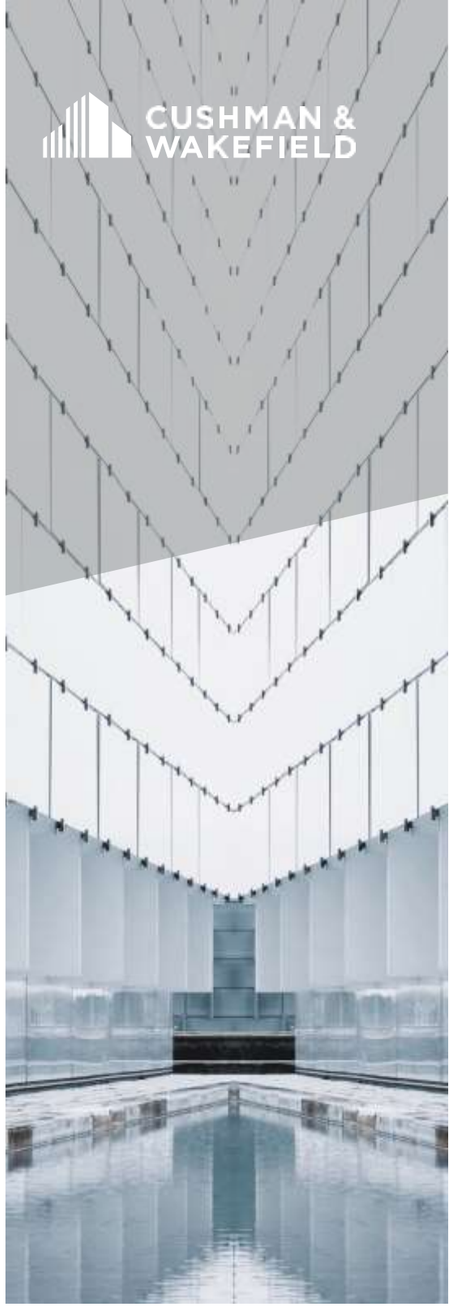
- Space demand has declined 45% q-o-q in Asia Pacific but remains in positive territory at the regional level so far.
- Widespread rental decline across the region in Q2, with more to come in H2 2020. Rental decline for full year 2020 is currently forecast to range from 5% to 15%.
- Remote working policies will reshape space demand, but this will play out over the longer term.

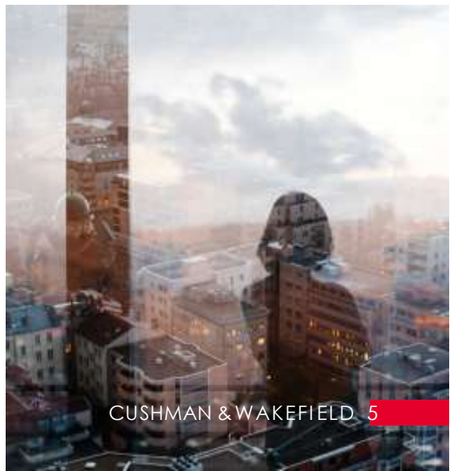
INDUSTRIAL MARKET

- Manufacturing has been most impacted in the industrial sector, affected by disrupted supply chains and lower demand.
- Other operators within the industrial sector have grown and indeed thrived, given increased demand from e-commerce. Three key sectors include logistics, warehousing and cold storage.
- Medical and pharmaceutical sector tenants to lead demand over the medium term.

INVESTMENT MARKET

- Investment volume down in H1 by 42% y-o-y. Pricing is largely stable, though there is weakness in retail and hospitality.
- The industrial market is proving most resilient. Volume is down only 12%, mainly due to less available stock.
- Transaction activity to improve in H2 2020 but remains below trend. Cautious investors are weighting their attention to stabilised assets in core locations.
- Limited signs of distress so far, but pre-distress or portfolio rebalancing may create acquisition opportunities.





STRATEGIES TO RECLAIM 2020

OCCUPIERS

- Carefully think whether to surrender/sub-lease space. Markets are likely to be flush with options resulting in low returns for sub-lessors.
- Align financial goals with CRE strategy, flexible working policies and change management to enact workplace transformation.
- Office workplace design, technology, wellness and wellbeing are high priorities.
- Facilities management will need to become increasingly nimble and more focused on user experience than tactical delivery. Wellness standards and touchless technology to increase in importance.

INVESTORS

- Work closely with lenders to maintain debt levels and where possible secure lending for new investment opportunities.
- Safeguard portfolio occupancy– new leasing and tenant retention are imperative.
- Accelerate development opportunities in logistics and warehousing with rising occupier demand.
- Proactively seek sale-and-leaseback opportunities.
- Keep a close focus on price softening on pre-distressed assets or where existing owners need to rebalance their portfolio.

WHAT TO WATCH

- Sectors: TMT, Healthcare, BPO, e-commerce
- Long WALEs
- Portfolio Strategy
- Reimagining the workplace
- Finance/HR/CRE/IT strategic collaboration
- Asset classes: logistics, warehousing, cold storage and data centres
- Capital preservation
- Sale and leaseback
- Opportunistic asset purchasing

ECONOMY

INTRODUCTION

It is hard to overstate the economic impacts that have been felt as a result of the COVID-19 pandemic. In effect, the whole world has been placed on pause as economies, borders and workplaces have been temporarily closed to stem the spread of the virus. It is not surprising therefore that Q2 2020 data has set many records, and not positive ones.

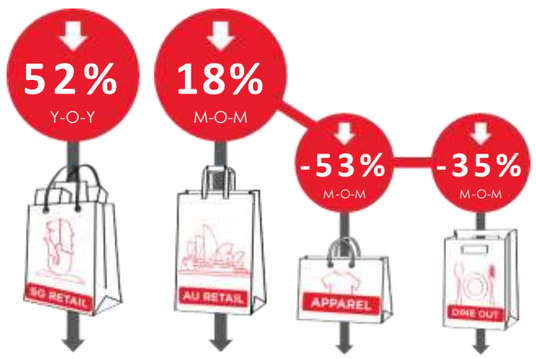
However, just as Q12020 was a two-speed quarter as countries felt the full force of the virus and subsequent lockdowns, so too was Q2 a two-speed quarter as some economies started to emerge the other side[1].

This is not to say that the recovery will be easy, linear or that the downturn will not leave scars. Rather that the focus should be on setting proactive strategies to reclaim growth opportunities as consensus views still maintain a rebound in growth in 2021, though at varying speeds and trajectories.

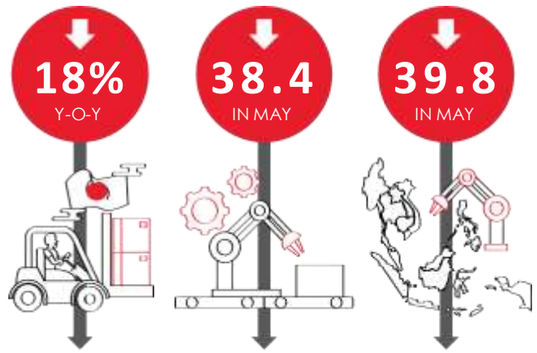
Q2 WAS BRUTAL FOR MOST

Practically every major economy in Asia Pacific recorded negative GDP growth quarter-on-quarter in Q12020. Unsurprisingly, with China the first to initiate lockdowns it was also the economy that saw the largest decline of nearly 30% q-o-q, not accounting for seasonal variation. Hong Kong and the Philippines both recorded double-digit declines, with Q12020 in Hong Kong being its worst on record at -12%.

Outside of mainland China, GDP estimates for Q2 2020 are generally predicted to be worse than Q1. The decline was driven by unemployment spikes, as most economies in the region locked down (Figure 1; Figure 2). Consequently, many indicators have turned deeply negative and it's not difficult to find bad news. Amongst the highest on the list include retail sales, manufacturing and tourism.



In Singapore, retail sales plummeted 52% y-o-y in May. Month-on-month declines in April highlight the impact of the lockdown in Australia with total retail sales declining 18% m-o-m, but with apparel sales and dining out showing the steepest declines at -53% and -35% m-o-m respectively.



Export volumes in Japan declined by over 18% y-o-y in April with the manufacturing PMI in May sitting at 38.4 (below 50 indicates a contraction). Similarly, the manufacturing PMI for ASEAN sat at 39.8 in May.

Inbound tourist numbers in Hong Kong dropped to approximately 100 per day in April 2020 compared to over 185,000 per day a year ago. Steep declines in tourism have affected the whole region but the effects are being hardest felt in the Philippines, Thailand and Malaysia where the sector contributes over 15% to national GDP.

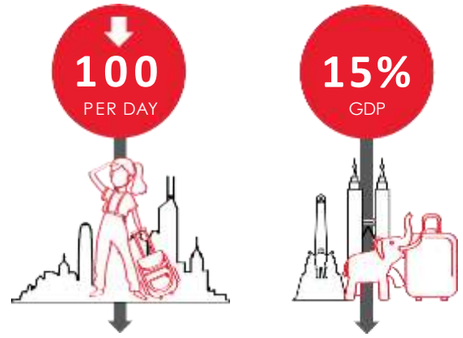
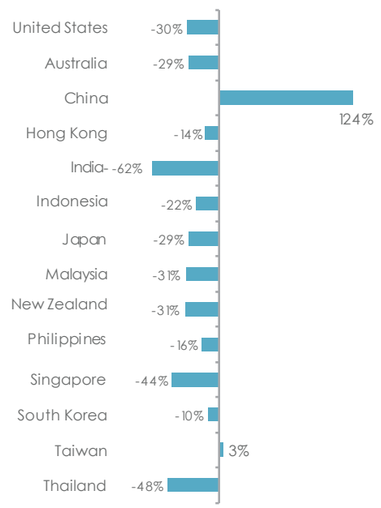
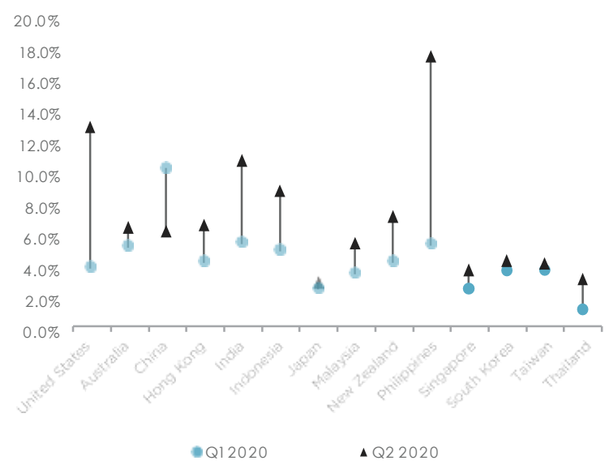


FIGURE 1 Q2 GDP GROWTH
(Q-O-Q ANNUALISED)



Source: Oxford Economics; Cushman & Wakefield Research

FIGURE 2 QUARTERLY UNEMPLOYMENT



Source: Oxford Economics; Cushman & Wakefield Research

[1] Reopening tracker: https://www.cushmanwakefield.com/en/insights/covid-19/global-economy-reopening-tracker

GREEN SHOOTS ARE STARTING TO APPEAR

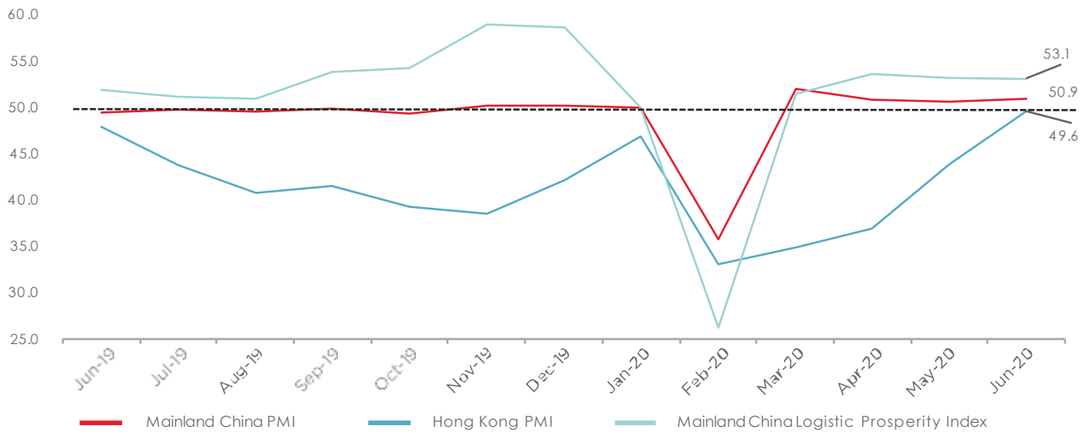
As devastating as these numbers are, it is important to note that the most severe declines occurred in April and May. As high-frequency data for June became available, we are starting to see green shoots of recovery appear, helped in no small part by the size of the fiscal and monetary response[1]. China posted robust economic growth of 12.4% q-o-q, manufacturing PMIs have moved off recent lows (Figure 3), Asian REITs closed the second quarter 13% higher, retail data suggests that consumers are starting to spend again, and people are beginning to return to their workplaces.

The other key aspect has been Government's ability to contain the virus – the countries that have been most effective in doing this, have been able to reopen more quickly and kickstart their recovery.

Current forecasts and analysis suggest a three-speed recovery based upon a country's economic and health vulnerability to the pandemic; the stringency and length of lockdowns; success in containing the virus; and level of macro-policy response (Figure 4). However, the composition of these groups is likely to be fluid as waves of the virus resurface.

- **Group 1(top/fastest):** Vietnam, South Korea, Taiwan, Japan, Mainland China, Hong Kong and Australia[2]. China gains from lower levels of vulnerability and less economic harm from lockdown. Both Vietnam and South Korea achieved high virus containment without a prolonged, stringent lockdown.
- **Group 2 (middle):** Singapore, Malaysia and Thailand. Singapore has provided a large fiscal response but suffers from stringent lockdowns and ongoing high caseload. Thailand and Malaysia had weaker policy responses.
- **Group 3 (bottom/slowest):** India, Philippines and Indonesia. All are still struggling to get past peak of the pandemic and had some of the most stringent lockdowns globally which were not matched by the policy response.

FIGURE 3 GREATER CHINA PMI SCORES JUNE 2019 – JUNE 2020

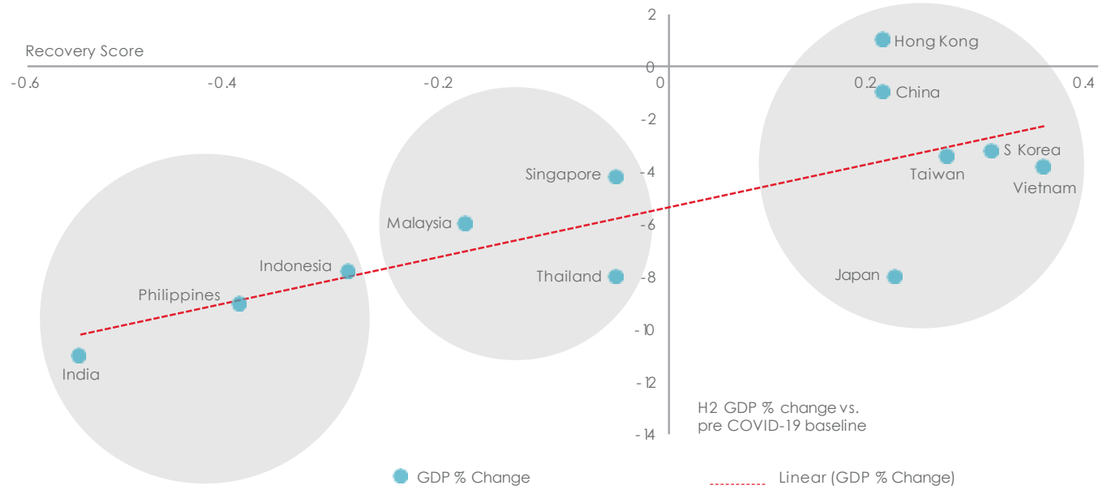


Source: Trading Economics; China Logistics Information Centre; CFLP; Yahoo Finance; Cushman & Wakefield Research

[1] Policy tracker:https://www.cushmanwakefield.com/en/insights/covid-19/policy-watch-economic-measures-across-top-global-economies

[2] Cushman & Wakefield estimation

FIGURE 4 ASIA PACIFIC'S THREE-SPEED RECOVERY



Source: Oxford Economics; Cushman & Wakefield Research

OUTLOOK

Overall, the situation remains extremely volatile – the macro forecasts come with a literal health warning. On a trend basis, though, we can provide some key messages:

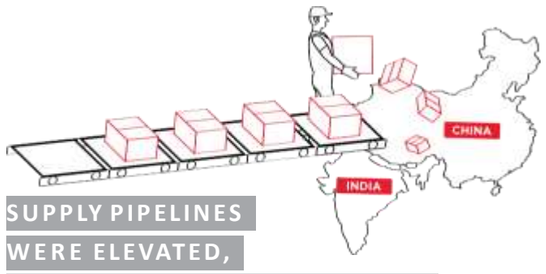
- Asia Pacific entered the crisis earlier than other regions, is largely managing to contain the virus and as such is seeing restrictions ease more rapidly than elsewhere around the world. This has provided a recent bounce in some indicators.
- Ongoing virus "hot spots" highlight that downside risks are far from over, but the region is once again showing its resilience.
- The extent and speed of the Asia Pacific rebound is reliant upon rebuilding global trade. This, in turn, is dependent on the world's other major global economies also being able to enter recovery mode. Consumer confidence remains key, which is fundamentally reliant upon global containment of the virus and a widely available vaccine.

OFFICE MARKETS

The pandemic has dealt a severe blow to corporate performance, which is echoing through real estate footprints as many seek to manage costs. It is inevitable therefore that markets across the region have softened and are expected to soften further; but it is important to remember that the majority of markets came into the pandemic in solid shape.

FIVE OUT OF THE TOP 10 TIGHTEST MARKETS IN THE WORLD WERE LOCATED IN ASIA PACIFIC

THE REGION ACCOUNTED FOR HALF OF GLOBAL NET ABSORPTION IN THE YEAR TO Q1 2020



SUPPLY PIPELINES WERE ELEVATED, BUT MAINLY CONCENTRATED IN CHINESE AND INDIA MARKETS

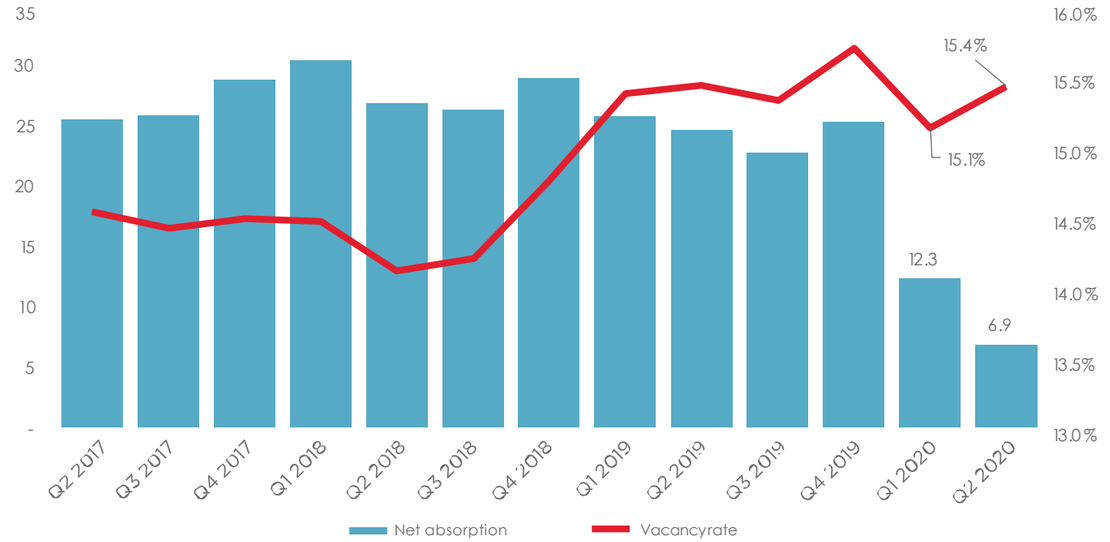
"RISK-OFF" STYMIES DEMAND

From a corporate occupier perspective, it is very much "risk-off" and many non-business-critical decisions have been put on pause. New enquiries for space were down and regional net absorption has softened further from 10.1 million square feet in Q1 2020 to 6.9 million square feet in Q2 2020 – only 30% of the three-year rolling quarterly average (Figure 5).

Within this overall figure there have been some brighter spots. Indian markets recorded 3.7 million square feet of positive net absorption in Q2, albeit this was a 50% decline q-o-q and the softest result since 2013. More positively, Tier 1 markets in China returned to positive net absorption after a particularly soft first quarter. While these may only be considered mildly positive, they stand in stark contrast against the almost 23 million square feet of negative net absorption recorded across US markets, further highlighting the resilience of the region so far.

The pandemic has not affected all sectors equally. In India, the IT-BPM sector accounted for 43% of gross leasing in the quarter, up by eight percentage points y-o-y. Large proportion increases in space demand were also seen in the healthcare and pharmaceutical sectors. In Shanghai the top three industries driving demand were Financial Services, Professional Services and TMT. Notably these were domestic entities as MNCs remain cautious about the future.

FIGURE 5 ASIA PACIFIC QUARTERLY NET ABSORPTION (MILLION SQ FT)



Excludes Australian markets
Source: Cushman & Wakefield Research

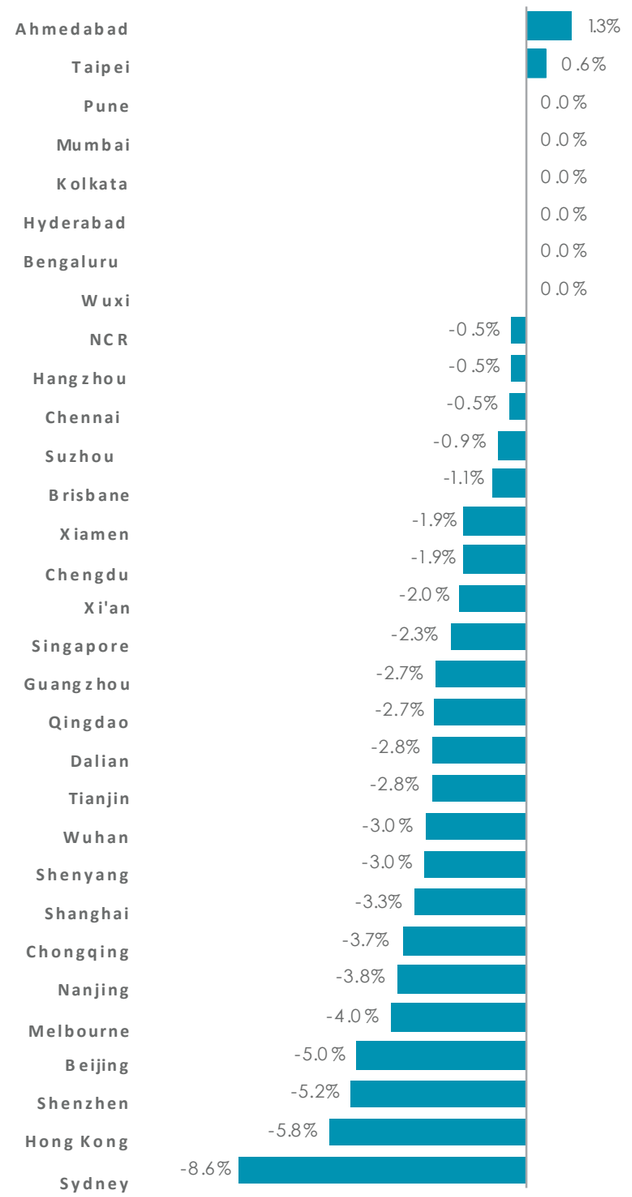
RENTAL DECLINE, NOT COLLAPSE

Landlords have acted swiftly to remain competitive in a softening market. Rental declines for new leases have been practically universal across Asia Pacific, either through face rent adjustments or increased incentives. Sydney saw the sharpest decline in the Q2 2020 at 8.6% with the average across the region at approximately 2% (Figure 6).

Although there was an initial rush from some tenants to secure rent abatements or waivers, unless mandated by enacted Government policy, their success in doing so has been patchy at best. That's not to say landlords have not been amenable to working with tenants in financial difficulty, but that rental write-offs have not been common. Most tenants continue to occupy their space and pay their rent, resulting in only modest market-level rental declines in the face of weak sentiment.

Landlords should continue to focus on securing building and portfolio occupancy levels. At the start of the year, the region had a new supply pipeline of over 600 million square feet – most of it in China and India. Although much of the longer-term supply is likely to be delayed, we saw new completions in the region cause vacancy to tick up to 15.4% from 15.1%. As tenants look to consolidate their footprint, weaker tenant demand could exacerbate the effects of any further new supply.

FIGURE 6 ASIA PACIFIC Q2 Q-O-Q RENT GROWTH



Source: Cushman & Wakefield Research

However, corporates should tread carefully here. There is likely to be a glut of sub-lease space on the market as corporates pursue similar rationalisation strategies – available sublease space in Sydney has reached levels last seen during the GFC – and so achievable rents are likely to be well below former market levels. Additionally, many sub-markets remain especially tight. Any space surrendered now may not be easily regained in the future once the recovery gathers momentum.

Q2 QUICK STATS:

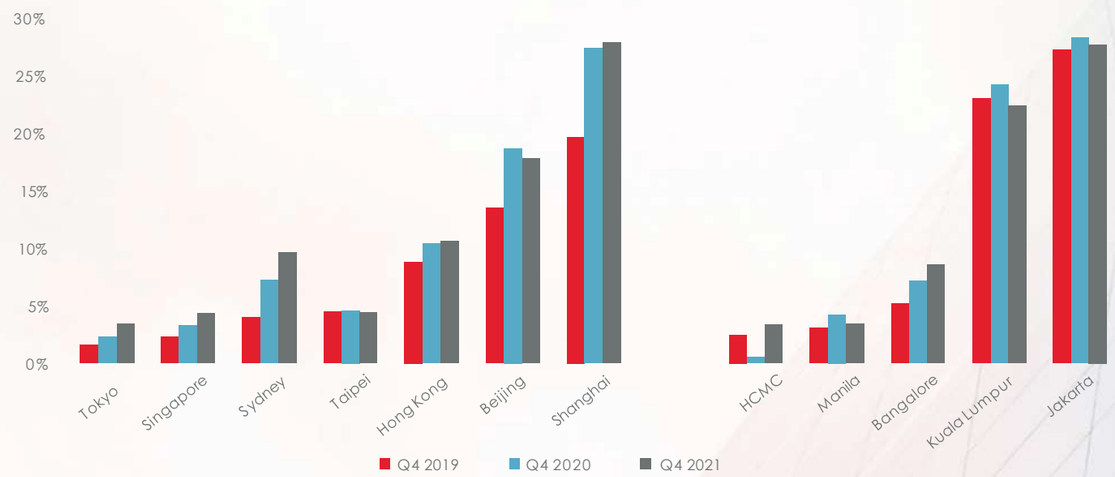
CORPORATE STRATEGY TO DRIVE MARKET OUTLOOK

Although the region entered the pandemic in relatively robust shape, small pockets of weakness were emerging, which the pandemic has exposed and accelerated predicted trends from the start of the year. We expected neutral markets to become more tenant friendly and landlord friendly markets moving to a more neutral, or even tenant friendly position. This has unfolded more rapidly than expected. As at Q2 2020 just four markets in the Asia Pacific region remain landlord friendly, down from 11at the start of the year and all four are reporting softening conditions.

Although there are green shoots of emerging economic recovery, CRE markets will lag this recovery and likely continue to soften over the next six months. We expect total rental declines for the year to average 5% but ranging up to 15% for markets that were already encountering headwinds prior to the pandemic. The vacancy outlook though is much more nuanced, reflective of the wide range of conditions between markets (Figure 7; Figure 8).

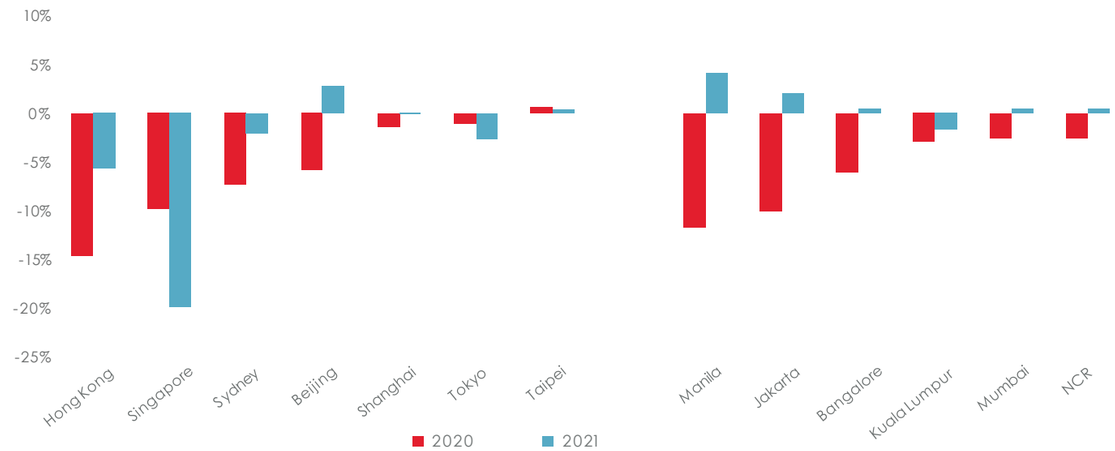
Space needs are evolving, driven by cost reduction and greater employee flexibility. The speed at which these workplace strategies can be deployed is dependent on several factors, but ultimately require the alignment of financial goals with corporate real estate strategy, HR policies and change management practices. Expect this to continue to play out over 2021 and beyond.

FIGURE 7 GRADE A OFFICE VACANCY FORECAST



Source: Cushman & Wakefield Research

FIGURE 8 GRADE A OFFICE ANNUAL GROSS EFFECTIVE RENT GROWTH FORECAST



Source: Cushman & Wakefield Research

WHAT OCCUPIERS ARE THINKING:

- How and when to return to the office
- Cost containment and capital preservation
- Use of technology to drive lasting change
- Space consolidation —focus on lease admin and local market dynamics to identify opportunities
- Develop forward-looking flexible working policies ready for future lease expiries
- Managing capital expenditure versus operational expenditure
- How to redefine the role of the office

WHAT INVESTORS ARE FOCUSED ON:

- A laser focus on client needs —proactively engage with tenants and be nimble
- Income security — understand your tenants —who is recession proof and who is more vulnerable
- Asset positioning — first impression is key
- Implications for asset value and loan serviceability
- Reassess investment/divestment strategies — capital recycling into growth markets

INDUSTRIAL

The industrial sector has shown greater resilience during the pandemic so far, but the decline in world trade figures highlight that it has not escaped unscathed. On the negative side, companies that are reliant on the movement of goods or people have been the most affected. Airlines around the world have been grounded with seat capacity in Asia declining by 52% between January and June, highlighting the lack of domestic and international travel.

MANUFACTURING IS STARTING TO RECOVER

Strict restrictions on people movements in China saw manufacturing output plummet in February to April, which restricted downstream manufacturers' ability to secure component parts. Since this time, Chinese manufacturing has rebounded strongly, defying growth expectations as demand has held up better than anticipated in other regions. Similar export headlines are emerging elsewhere around the region suggesting a floor may be under the manufacturing sector. Cost containment remains key, prompting some enterprises to reconsider their balance sheets against their real estate portfolio, giving rise to the prospect of sale and leaseback opportunities for investors.

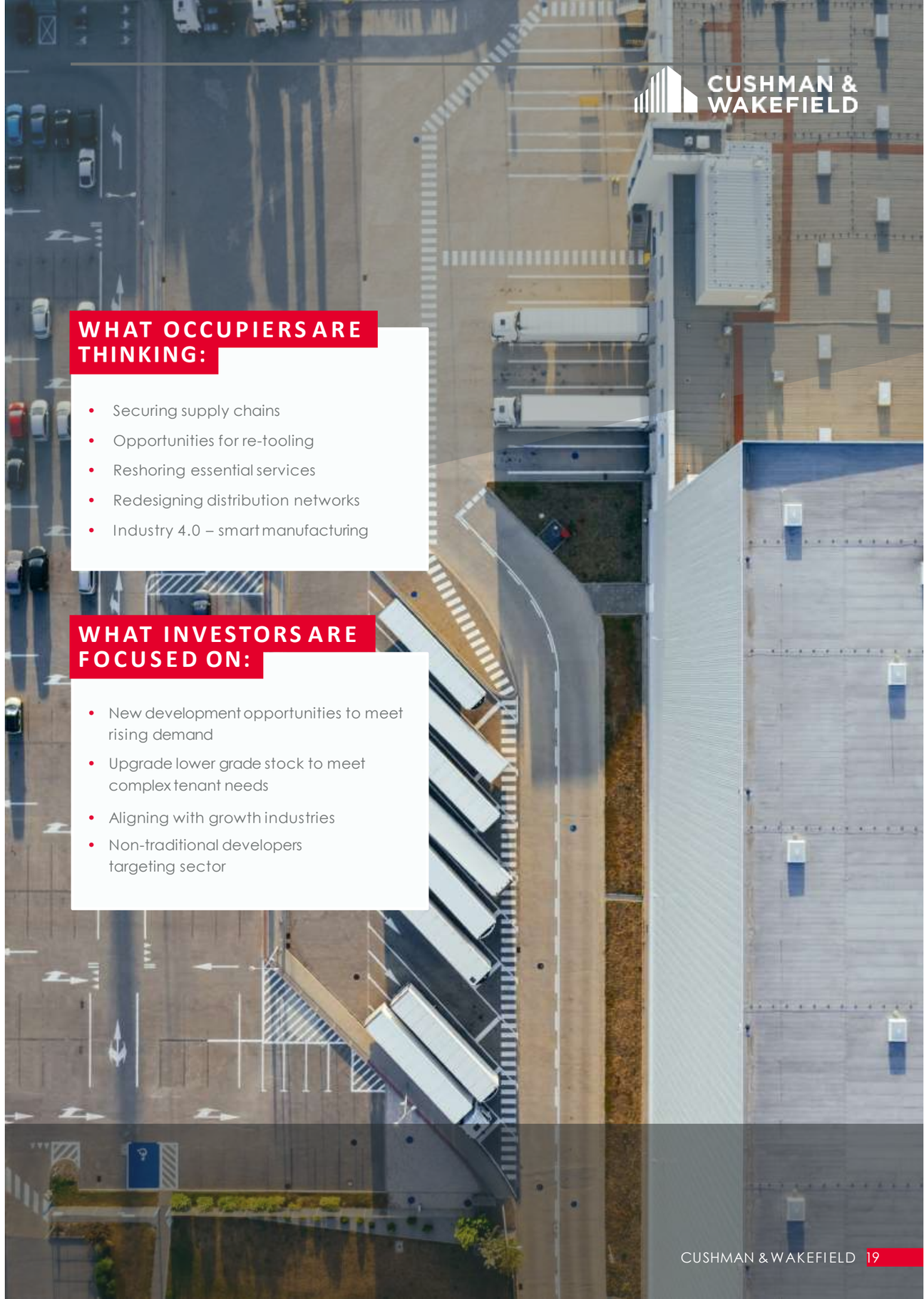
LOGISTICS AND WAREHOUSING POWERING AHEAD

More positively, the pandemic has seen other operators within the industrial sector grow and indeed thrive. Three key sectors include logistics, warehousing and cold storage. In Australia, Australia Post has taken more space to accommodate unprecedented demand as restrictions on people movement have forced consumers to use e-commerce channels for all but essential shopping.

Similarly, there has been greater demand for warehousing and cold storage as operators have sought to stockpile goods to shore up depleted supply chains. The cold storage sector in China is forecast to grow by 20% in 2020 to double in size in the last four years. At the market level this has translated into increasing rents as seen in the 5.7% q-o-q increase for premium logistics space in Shenzhen. Similarly, in Singapore and Vietnam rents continue to trend up for prime logistics space. Furthermore, some third-party logistics (3PL) operators in these markets are bringing forward planned expansion activities to capitalise on demand.

FUTURE OPPORTUNITIES IN BIO-MEDICAL HUBS

Overall the outlook for the industrial sector remains more favourable than other sectors, though headwinds remain. Until global consumer confidence gains strength, manufacturers are likely to remain under pressure. Counterbalancing this, in the near term, logistics and warehousing sectors will continue to see elevated demand – base demand for their services is unlikely to return to pre-COVID levels. In addition, essential services are likely to be re-shored, giving a boost to domestic industrial markets. Indeed, supply chains are being reworked more broadly to hedge against similar disruptions in the future, which will benefit emerging industrial markets. Looking to the future, key pharmaceutical and bio-medical hubs around the region are likely to experience a ground swell in demand over the medium term.



CAPITAL MARKETS

Q2 BRINGS MIXED NEWS FOR INVESTORS

It has been a difficult year so far for the commercial real estate investment market. The overall regional investment volume were down by almost 40% y-o-y in Q1 2020 at US$117bn – the softest quarter since Q12016 in which US$106bn of transactions was recorded. From early analysis of Q2 data, there appears to be mixed news. On the positive side, volume picked up to approach US$150bn, however this is well below the three-year rolling quarterly average of US$205bn. The implication is that investment in 2020 is likely to fall well below last year's totals (Figure 9). Deployment of capital, of which there remains an abundance, is likely to remain challenging.

RETAIL VOLUMES DOWN SHARPLY, INDUSTRIAL STANDS FIRM

At the sector level, investment in all asset classes is well below rolling averages, though investment in the retail and hotel sectors have been hardest hit with both recording anaemic volumes in H1 2020 – down 58% and 51% y-o-y respectively. Office investment also weakened dramatically, down 49%, to $24bn.

In contrast, the defensive qualities of the industrial sector have sustained investor interest and while volume is down year-on-year, the decline has been less dramatic than in other sectors at 12% for H1 2020. Indeed, in Australia, Q2 2020 investment in industrial assets almost exceeded that of the office sector at AU$1.64bn and AU$1.67bn respectively. It has been a decade since these two figures have been so closely matched.

VALUES UNDER PRESSURE, BUT REMAINING STABLE FOR NOW

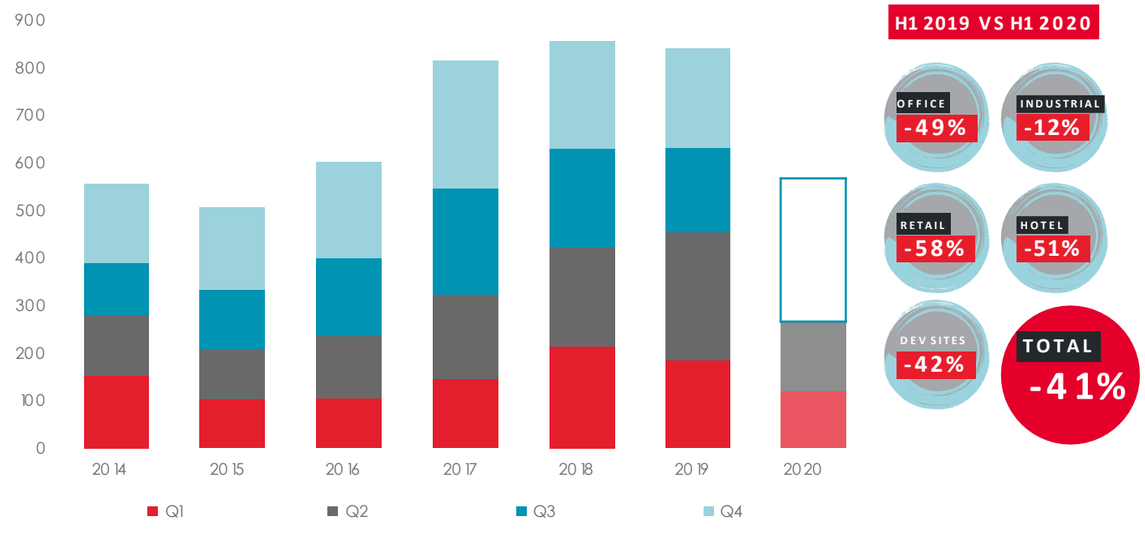
The uncertain economic outlook and lack of clarity of the short- and medium-term impacts of COVID-19 on occupier markets have made valuing assets substantially more difficult. In turn this has led many investors to sit on the sidelines, while for those more actively looking to trade there is an increasing divide between vendor and purchaser pricing expectations.

However, we have seen little change in capitalisation rates so far, though this is likely in part due to the limited number of assets trading as many owners are reluctant to sell and lock in potential losses. Similarly, there is little evidence of true distress in the market at the current time, but this may become more apparent if the outlook worsens or banks become more conservative on lending policies. With this, new leasing and tenant retention are paramount for landlords.

In time though, hospitality and retail asset values will come under closer scrutiny and the loss of income from lower occupancy and sales will inevitably be reflected in any valuation. The office sector to an extent and industrial sector should be more resilient, though average lease expiry and tenant covenants will influence pricing.

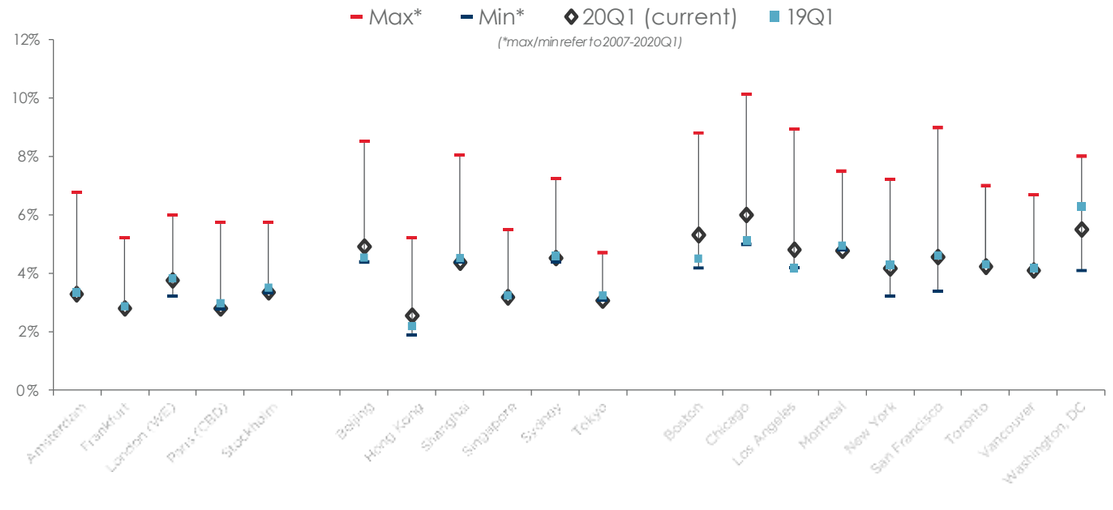
More broadly, with interest rates at or near record lows and very low hurdle rates, commercial real estate is likely to remain a preferred investment class on account of its higher risk-adjusted returns and longer-term growth prospects. Expect investors to actively seek opportunities all along the risk curve (Figure 10).

FIGURE 9 ASIA PACIFIC ALL PROPERTY INVESTMENT (USDBN)



Source: Real Capital Analytics; Cushman & Wakefield Research

FIGURE 10 PRIME OFFICE CAPITALISATION RATES



Source: Real Capital Analytics, Altus Insite Investment Trends Survey, Cushman & Wakefield

OUTLOOK

It is without doubt an exceptionally challenging time for occupiers and investors alike. The impacts of COVID-19 have been swift and dramatic, with further downside risks likely to echo for some time yet. However, just as boom cycles come to an end, so too do bust cycles. There are green shoots of economic recovery already emerging across the region.

In economic terms, H2 2020 is forecast to be a stabilising period, before stronger economic growth returns in 2021. Commercial real estate markets will lag this recovery. Space demand and rents are forecast to soften further over the second half of the year. Investment volumes may well improve over the next six months, but in relative terms will remain soft compared to the longer run average. Pricing for quality assets should remain competitive, though weaker assets with vulnerable income streams will come under greater scrutiny from opportunistic investors.

The speed at which these changes occur will vary between markets, requiring a proactive and flexible approach by both occupiers and investors. Reclaiming the outlook will not only help corporates navigate this downturn but also position themselves for when the recovery takes greater hold.

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