CBRE Asia Pacific Research | Capital Markets Viewpoint

Uncovering value late in the cycle: Where should investors look in 2019?

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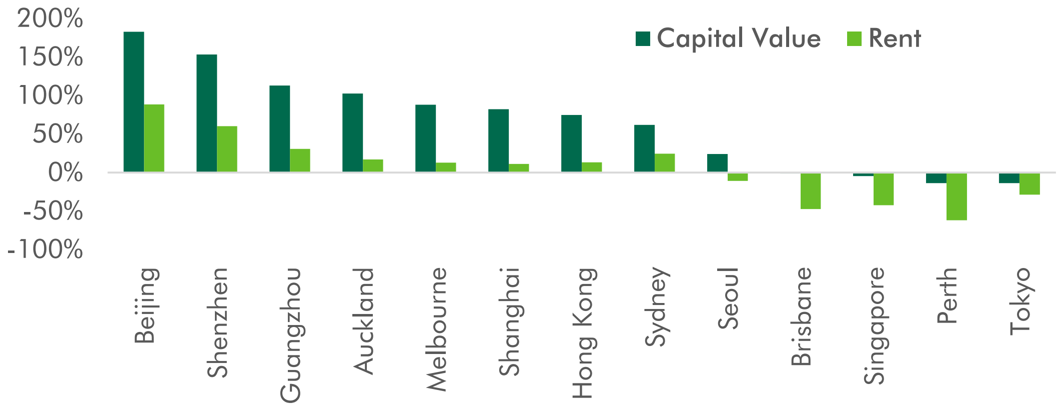
Introduction

Asia Pacific continues to enjoy one of its longest ever periods of uninterrupted economic expansion, driven by supportive monetary policy and robust growth in China.

However, end-of-cycle concerns are growing amid a range of headwinds including U.S.-China trade conflict and financial market volatility.

In addition to these geopolitical and macroeconomic worries, real estate investors in Asia Pacific are faced with pricing that has already eclipsed the previous peak in most markets, even those offering low yields (Figure 1).

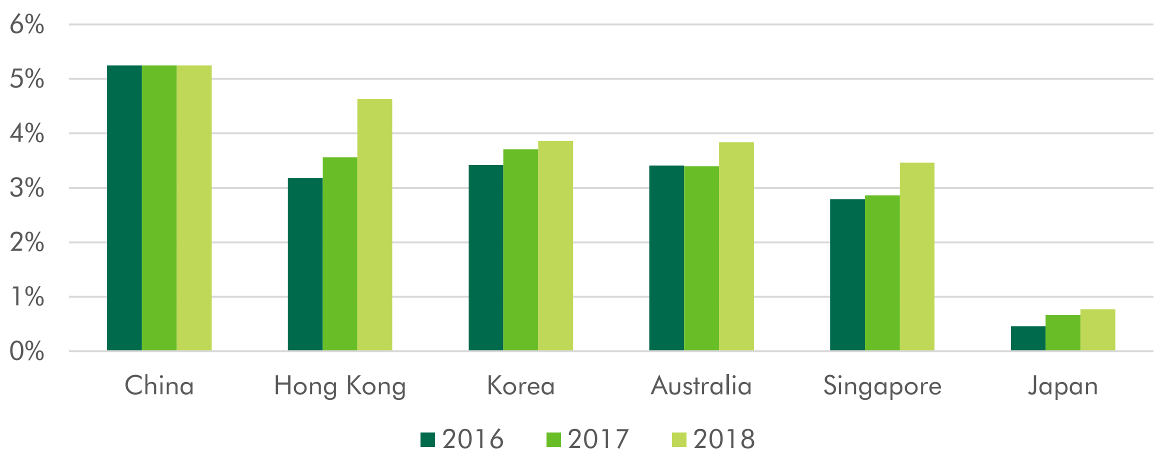
Figure 1: Grade A office capital values and rental growth compared to the previous peak in 2008



Source: CBRE Research ,February 2019.

The culmination of the era of cheap financing also poses a headache for many investors, with commercial property lending rates in major Asia Pacific markets including Japan, Korea, Hong Kong, Singapore and Australia all gradually increasingly over the past decade (Figure 2).

Figure 2: Commercial property lending rates in major Asia Pacific markets



* The commercial lending rate is the cost of borrowing for commercial property acquisition. It is calculated by adding the minimum interest rate spread to the reference rate charged by commercial banks.
Note on reference rate: Australia – 3M Bank Bill Swap Rate; China – 5 Year Lending Rate; Hong Kong – 3M HIBOR; Japan – 3M TIBOR; Korea – 3M CD Rate; Singapore – 3M SOR
Source: CBRE Research, February 2019.

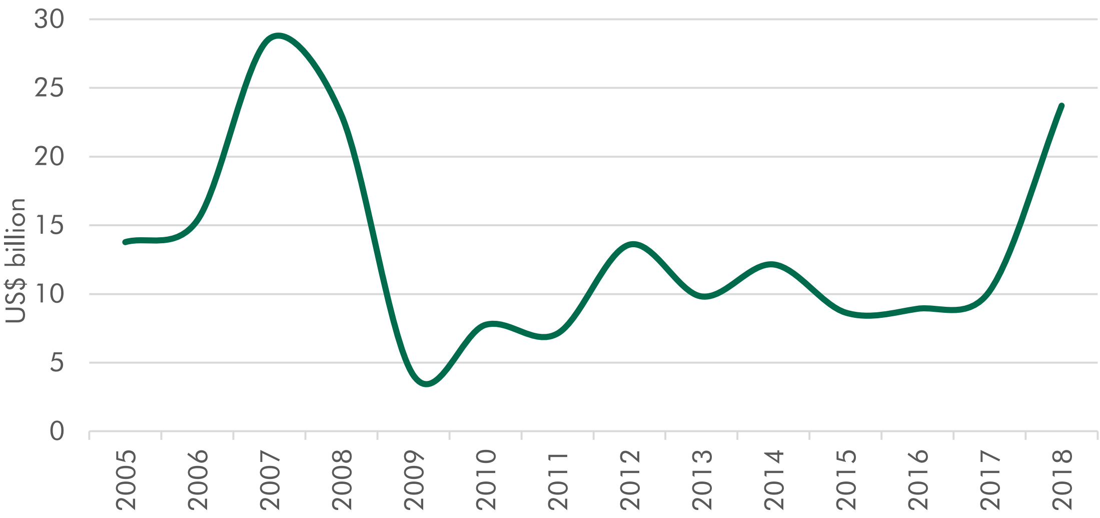
Asia Pacific real estate transaction volume fell by 10% y-o-y to US$126 billion in 2018, mainly due to the lack of tradable stock and the sizable price gap. However CBRE believes that overall investment demand remains strong, reflected by the rebound in purchasing activity towards the end of 2018, which saw transaction volume surge by 77% q-o-q in Q4 2018 to more than US$40 billion.

Market sentiment is upbeat

Although high prices, flat yields and the rising cost of borrowing will continue to somewhat impede investors from locating suitable investment opportunities in 2019, recent informal gauges of market sentiment by CBRE indicate continued solid demand from investors.

Indeed, there remains a deep pool of potential buyers, led by private equity real estate funds, which continue to benefit from the positive fund-raising environment (Figure 3).

Figure 3: Total equity raised by close-ended real estate funds focused on Asia Pacific



Source: Prequin, INREV/ANREV, CBRE Research, February 2019.

CBRE estimates that around US$62 billion of closed-ended private equity capital (after leveraging) will be deployed by Asia Pacific-focused close-ended real estate funds between 2019-2023. In addition, there is still nearly US$4 billion of capital earmarked for use this year by close-ended funds formed in 2014.

Add to this growing interest from western institutional investors including insurance companies, pension funds and sovereign wealth funds, and continued stable demand from property companies and REITs, then all indicators point to a substantial volume of capital aimed at Asia Pacific real estate in 2019.

From an individual market perspective, foreign investors are increasingly eyeing opportunities in China amid weaker competition from domestic buyers and the normalisation of asset prices.

Overseas investors acquired RMB 78 billion (US$11.6 billion) worth of commercial real estate in China in 2018, representing growth of nearly 70% y-o-y, and are expected to remain active in 2019.

CBRE is aware of several pan Asia Pacific-focused funds whose allocations to China are still underweight. Areas of focus will include decentralised offices and logistics facilities in tier I cities, along with non-performing loans.

Japan also offers some relative value compared to other markets. Grade A office capital values in Tokyo are still 14% below the previous peak set in 2008, with the prime yield versus borrowing cost remaining attractive. Regional cities, where prime properties offer further rental upside, will attract investors seeking higher yields.

Singapore Grade A office capital values are also below the previous peak, albeit only marginally, while rents are projected to record solid gains in 2019. CBRE sees some upside and opportunity in this market, although the window is shrinking rapidly.

CBRE also expects to see some profit-taking in 2019 as investors who entered the market earlier in the cycle dispose of assets now that yields are at historical lows, liquidity is still strong, and the cost of borrowing could increase.

Investment strategy

In an environment where it is challenging to locate immediate value, CBRE advises investors to consider a range of short-term strategies to take advantage of cyclical fluctuations, together with a stronger focus on long-term tactics to capitalise on structural changes.[1]

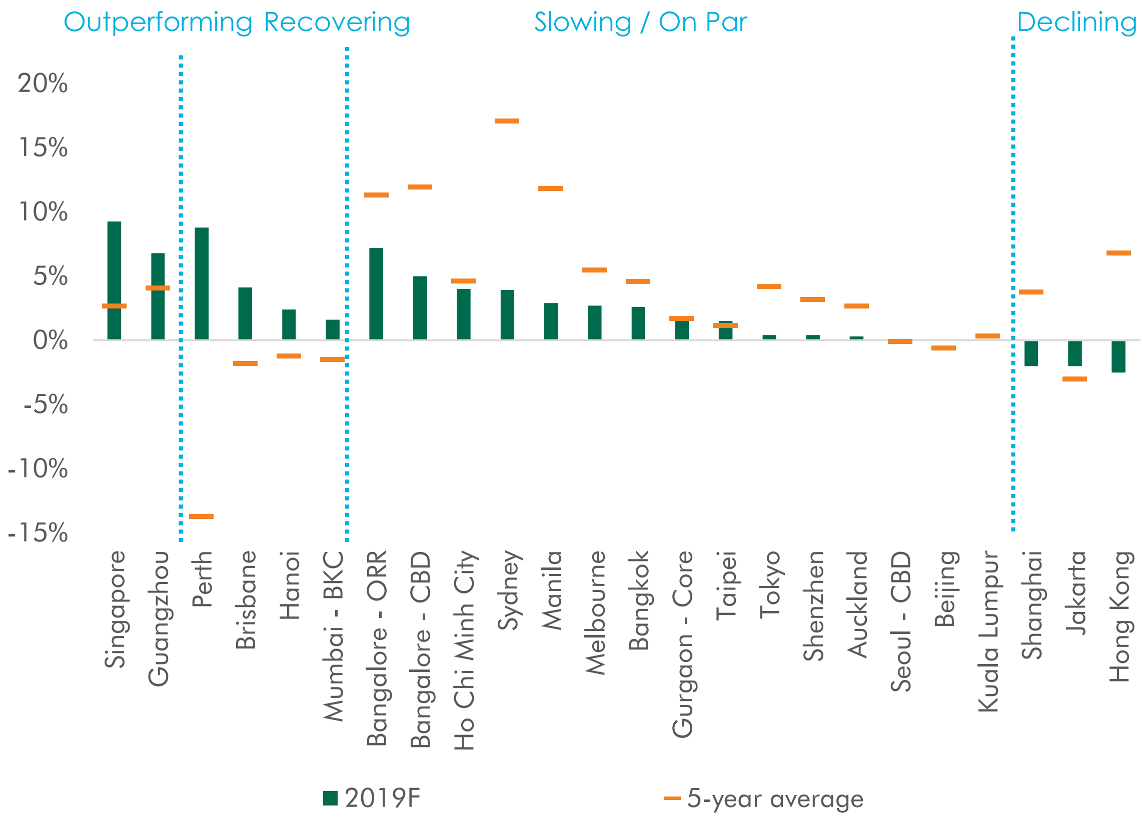
Cyclical opportunities – office and debt

Office markets continue to offer a range of cyclical opportunities, led by Singapore and Guangzhou, although these cities' lack of investable en-bloc office assets will confine investors to well-located strata-titled office opportunities.

Brisbane and Perth, where rents are now in the recovery phase, will provide prospects for counter-cyclical office investment plays (Figure 4).

1. CBRE 2019 Real Estate Market Outlook, CBRE Research, January 2019

Figure 4: 2019 office net effective rental growth by market



Source: CBRE Research, February 2019.

Other cyclical plays include capturing decentralisation demand arising from occupier cost-saving. Investors are advised to focus on new high specification Grade A office assets in non-core districts supported by new infrastructure.

CBRE has previously identified a range of real estate debt opportunities for investors to provide long term senior lending for asset acquisitions, as well as structured debt financing to development projects to fill the funding gap.[2]

Australia continues to offer prospects for engaging in senior loans and junior and mezzanine debt, while development loans, junior and mezzanine debt and non-performing loans will be the main route in China.

2. Focus Shifts to Debt Strategies as Market Cycle Matures, CBRE Research, November 2018

Structural opportunities – core assets, placemaking and alternative asset classes

Structural investment plays will be led by core assets, which remain ideal defensive investments. Well-located high-quality assets in mature markets are proven to withstand short-term market weakness and will remain keenly sought-after by long term investors, especially open-ended funds and listed real estate vehicles.

CBRE also advises investors to retain placemaking via asset enhancement as a critical component of investment strategy, especially in markets such as Hong Kong, China, Tokyo and Singapore, where prime yields are low. Placemaking should also include both office and retail components.

In terms of sector specific opportunities, built-to-core logistics facilities will remain a viable option for investors seeking to increase exposure to this sector.

Vietnam, which is expected to benefit from the relocation of manufacturing due to U.S.-China trade conflict in the medium term, and Indonesia, with its large population and solid consumption growth, will be a key focus.

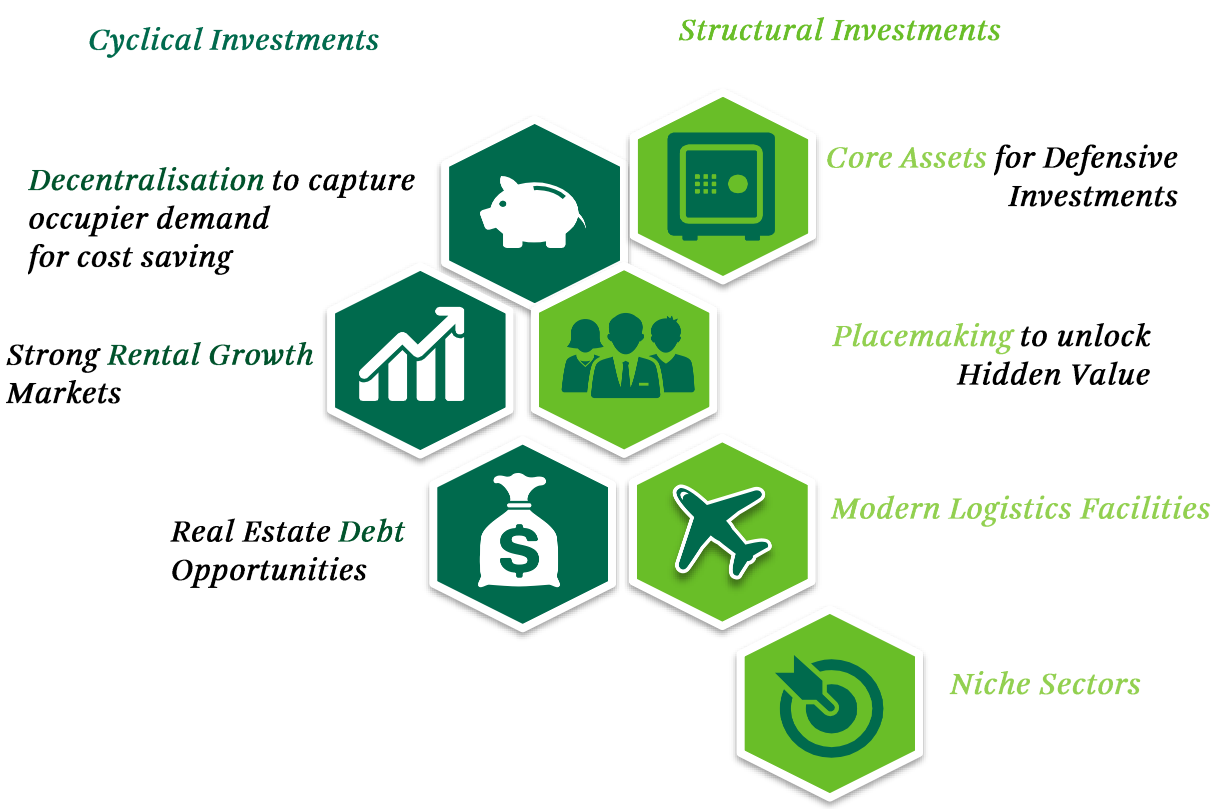
CBRE expects investment in these markets will be focused on greenfield development in partnership with local developers.

Investors are also recommended to monitor alternative sectors such as data centres and build to rent housing (multi-family) although accessing them admittedly remains challenging.

CBRE nevertheless sees considerable prospects for the latter in China, where authorities have recently issued additional policies to promote the development of long leased residential properties.

These include allowing the development of collectively owned land into rental housing. The government also reportedly plans to speed up the development of multifamily (build to rent) REITs.

Figure 5: Summary of key investment opportunities in 2019



Source: CBRE Research, February 2019.

Purchasing activity to continue

Although a range of market headwinds may weigh on investment market activity in 2019, with initial CBRE forecasts expecting total investment turnover to undergo a mild decline of around 5% y-o-y, there is no shortage of buyers. In many cases, turnover has been more limited by the lack of attractive assets, rather than an absence of demand.

The coming year is expected to be characterised by high liquidity, supported by the entry of new funds, the formation of new vehicles, and the deployment of new strategies into the Asia Pacific real estate investment market.

In addition to the strategies identified above, CBRE also expects 2019 to bring more opportunities for investors to participate in forward funding deals, as tighter bank lending to developers forces them to seek equity partners.

With some close-ended funds likely to put assets up for sale this year as they lock in profits on earlier investments, purchasers may benefit from an increase in the availability of assets for sale – opportunities that would be welcomed by many investors.

CBRE GLOBAL RESEARCH

This report was prepared by the Asia Pacific research team which forms part of CBRE Global Research –a network of preeminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate.

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