Research & Strategy
Positioning for income and growth in Asia-Pacific amid a changing global landscape

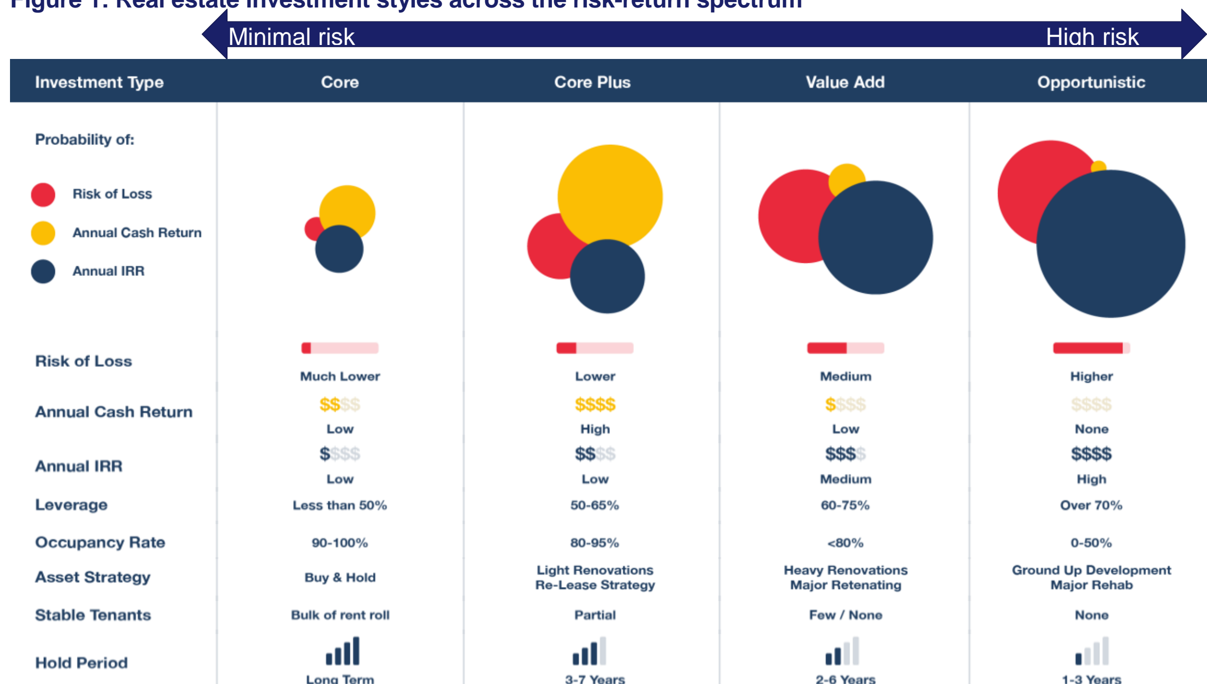
A lower-for-longer norm

A slowing global economy and a prolonged period of low interest rates is on the horizon, which poses a challenge to long-term investment. Risks have heightened from a year ago, stemming from anaemic economic growth, financial instability and geopolitical tensions. Leading indicators such as an inverted yield curve, a reversal in the US Federal Reserve's Rate hikes, downwards revisions to global economic growth forecasts and an escalation in the global trade wars (particularly the high-profile negotiations between US and China) reinforce this notion. This has led to investors adopting a risk-off mindset of late and raises the question: How should investors invest in a low interest rate, low growth environment at a time of heightened risks and global uncertainties?

We believe it is wise for investors to approach financial markets cautiously while sticking to a pro-growth, risk-on stance. The key is to create a portfolio that provides durable, resilient income while still being able to capture rental and capital growth from the continued economic expansion of the Asia-Pacific region, despite increasing regional and global headwinds.

Real estate investment strategies have expanded across the entire risk-return spectrum, from low-risk, low-volatility strategies – some of which offer almost bond-type characteristics (core style) – to higher-risk strategies with characteristics more akin to those of venture capital or traditional private-equity investing (opportunistic style) (figure 1).

Figure 1: Real estate investment styles across the risk-return spectrum



Investment Type	Core	Core Plus	Value Add	Opportunistic
Risk of Loss	Much Lower	Lower	Medium	Higher
Annual Cash Return	Low	High	Low	None
Annual IRR	Low	Low	Medium	High
Leverage	Less than 50%	50-65%	60-75%	Over 70%
Occupancy Rate	90-100%	80-95%	<80%	0-50%
Asset Strategy	Buy & Hold	Light Renovations Re-Lease Strategy	Heavy Renovations Major Retenating	Ground Up Development Major Rehab
Stable Tenants	Bulk of rent roll	Partial	Few / None	None
Hold Period	Long Term	3-7 Years	2-6 Years	1-3 Years

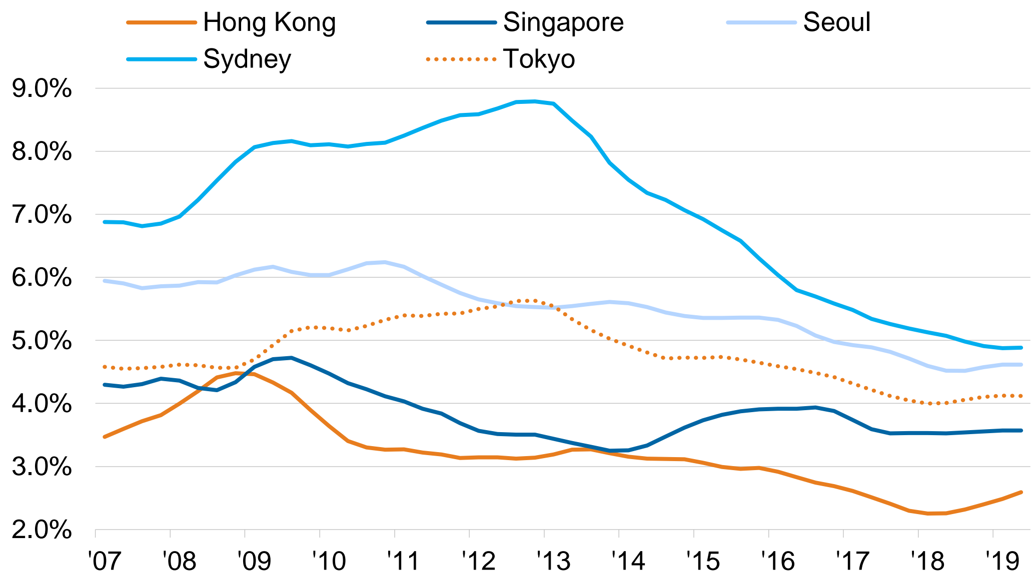
Source: Realcrowd

Navigating late-cycle headwinds

The current consensus from most institutional investors is that we are late in the property cycle. Navigating through a late cycle does not mean avoiding risk entirely, but more so identifying risks and knowing how to mitigate them through greater selectivity in asset profile. This includes understanding local market nuances and how regional diversification benefits portfolios. In the face of escalating global trade tensions, rising protectionism and the current climate of uncertainty, the potential of a US recession has risen, and Asia-Pacific would also undoubtedly be affected given its importance as a trade partner. This impact could range from reduced future regional growth prospects to increased volatility in currency valuation around the region. Positioning for income and growth in Asia-Pacific amid a changing global landscape

The current low-yield environment – and the expectation that interest rates will remain lower for longer – have whetted investors' appetite to move up the risk curve in terms of investment strategy. Property yields in gateway markets are now at historic lows compared to the last peak in 2007-08, although it is also important to note that the inflation and interest rate environment was significantly different then (figures 2 and 3).

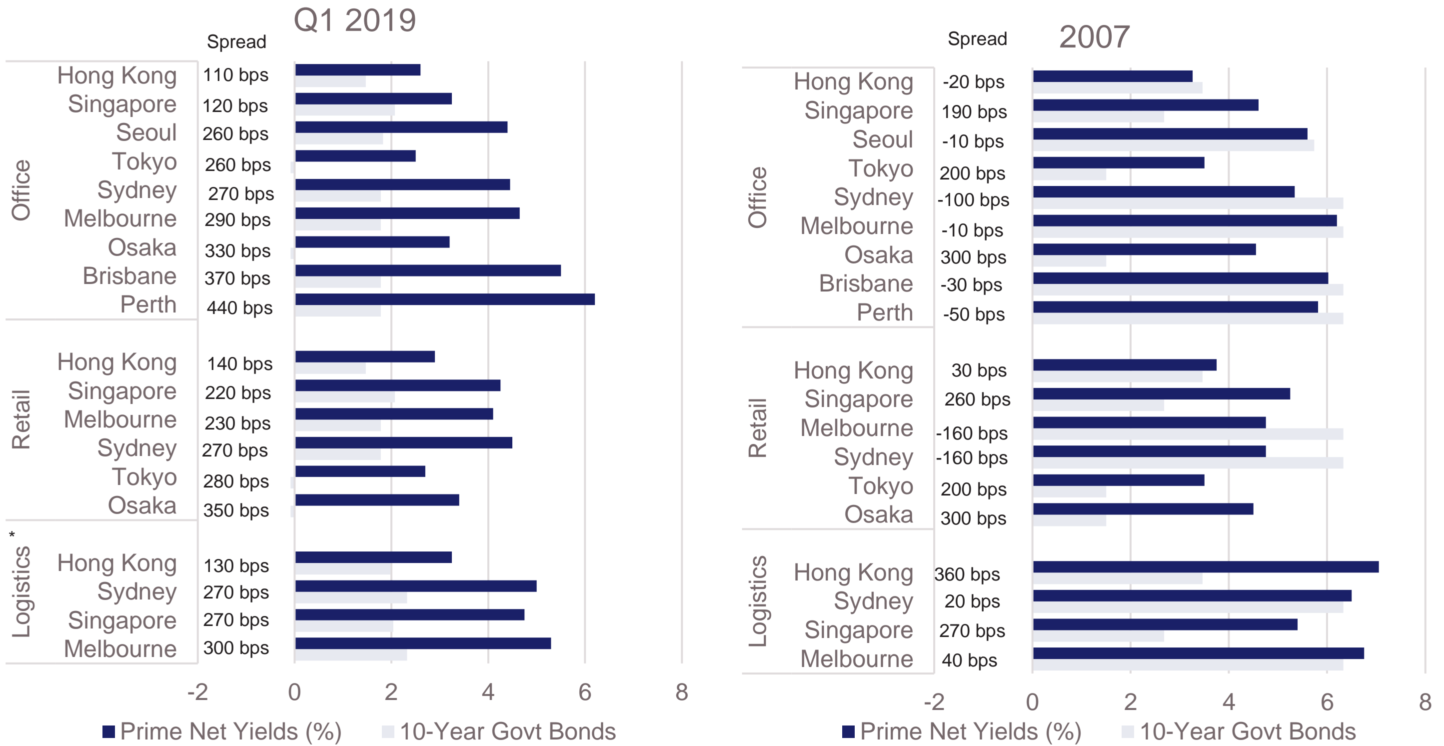
Figure 2: Transacted office yields in key Asia-Pacific markets



Source: RCA

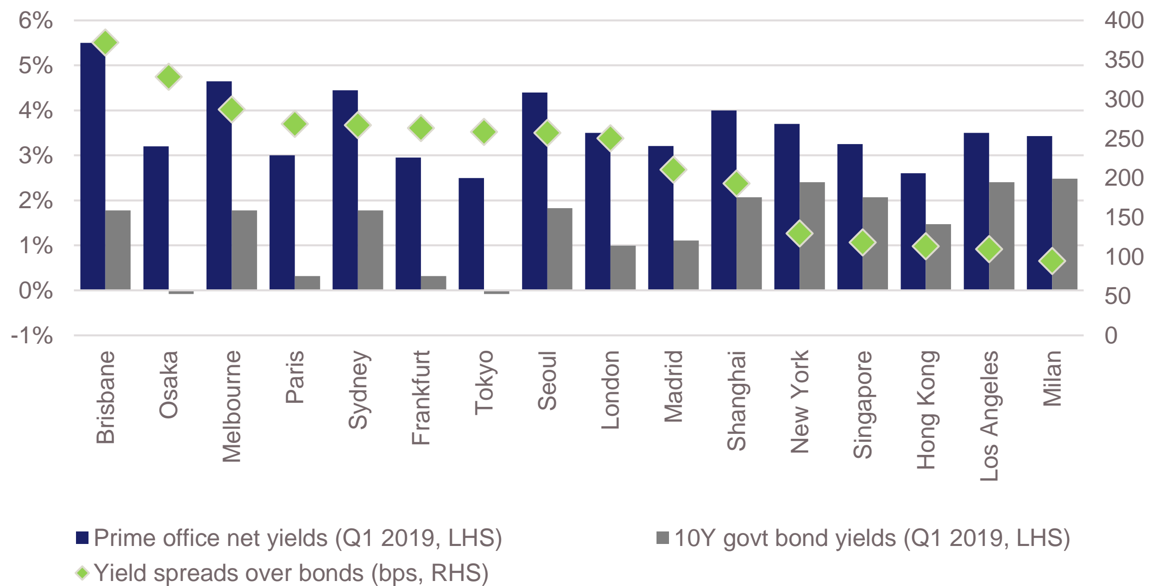
This has led to generous yield spreads in some Asian cities that are comparable to other global gateway cities (figure 4). Hence, it is important to take a holistic look at risk-adjusted returns across all asset classes today, while also layering in downside protection against demographic trends. This means moving up the risk curve without taking undue risks while also trying to meet investors' internal target hurdles. In this case, a core-plus/value-add strategy with a focus on income is likely the ideal strategy to mitigate risks, particularly in markets still exhibiting potential for growth.

Figure 3: Yields vs. risk-free rate (Q1 2019) and last peak (2007)



Sources: RCA, PMA, Oxford Economics
Note: *logistics data as of Q4 2018.

Figure 4: Prime office property yield spreads across global gateway markets

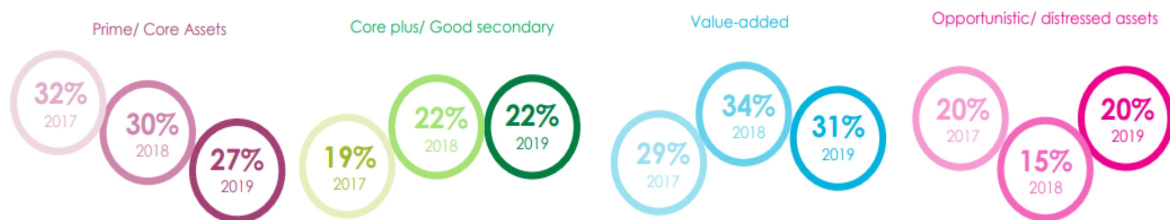


Sources: Oxford Economics, JLL, PMA

Assessing a core-plus approach

A decade of cheap debt and excess liquidity has stoked asset price inflation significantly. While the merits of owning core assets are clear, overpaying for them can be risky, especially in a late-cycle environment where yield spreads are narrowing in many markets, forcing investors to move up the risk curve. This is reflected in a preference for value-add strategies, according to a CBRE Asia-Pacific investor intentions survey (figure 5). In the same survey, investors also highlighted high prices as their main concern, although they still highly favour core assets.

Figure 5: CBRE's Asia-Pacific investor intentions survey: preferred investment strategy (2017-19)



Source: CBRE Research

Investors should consider the following in determining whether to adopt a core-plus approach in the current environment:

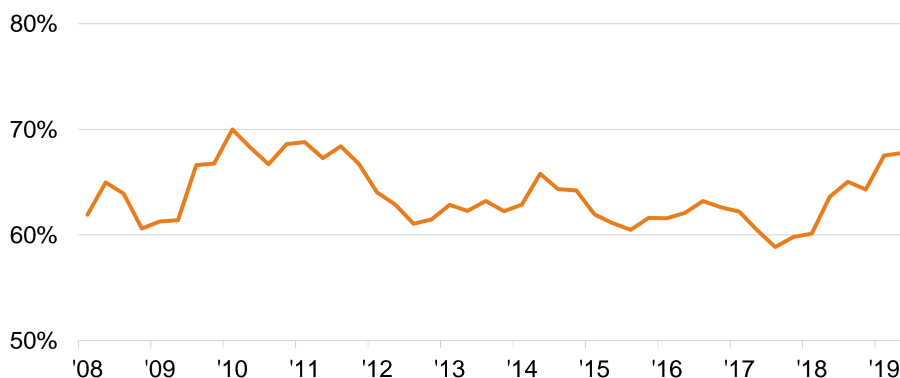
1) investment perspective
2) occupier perspective
3) risk-adjusted perspective

1) An investment perspective on core-plus

Evidence from RCA points to investor risk aversion as investment transactions tilt towards the top eight gateway markets/metros (Tokyo, Hong Kong, Seoul, Beijing, Sydney, Singapore, Shanghai and Melbourne) in region wide (figure 6). This shows strong appetite for assets in the core markets, which have accounted for more than 70% of total investment volumes over the past decade. At the same time, the lack of investable stock in Asia-Pacific compared to the other mature regions of the US and Europe implies an abundance of capital chasing core assets within the region, which supports low yields.

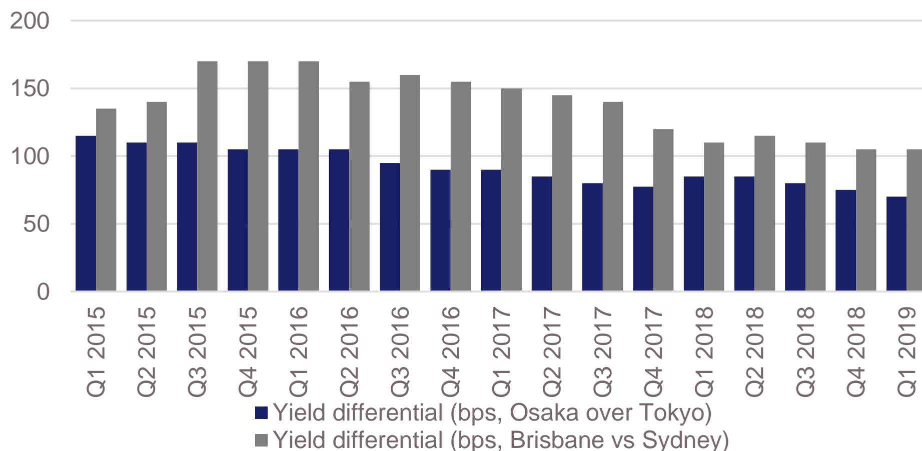
Post–global financial crisis, investors have also been moving out of core markets into secondary ones such as Osaka in Japan or Brisbane in Australia. As yields in core markets continue to compress to historic lows, these traditionally non-core markets have benefitted from spill-over, which has led to a narrowing yield differential (figure 7). Even within Tokyo, investors have been looking beyond the centre where there are more opportunities. This shows the merit of considering core-plus assets and markets instead of chasing after overly priced core assets, which are usually tightly held by owners.

Figure 6: Top eight metros' share of Asia-Pacific investment volumes



Source: RCA

Figure 7: Yield differential between secondary and core markets in Japan and Australia



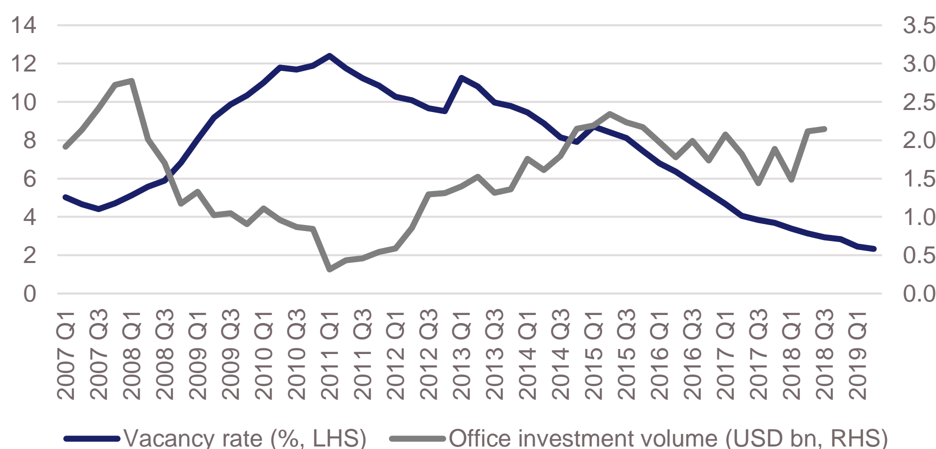
Source: PMA

2) An occupier perspective on core-plus

An in-depth understanding of local market dynamics is critical to mitigate risks while aiming to achieve core-plus returns in a core-plus market or location. For instance, an undersupplied central business district (CBD) market has the potential to achieve core-plus returns through pricing in the expected rental upside by taking on moderate risk to carry out works to boost rentals. Taking secondary markets such as Osaka as an example, a strong leasing market and tight supply have underpinned robust demand for Osaka office space. According to JLL, Osaka tenants are finding it difficult to relocate or expand due to lack of space. A key difference between Tokyo and Osaka is the latter's limited new office supply going forwards.

Structural changes such as infrastructure improvements also help boost the appeal of core-plus assets and markets. In the case of Osaka, the government's Umekita development project, centred around the Osaka rail station, is now in its second phase. The hub is set to host pharmaceutical and biotech firms upon completion around 2024. JLL reports that other major city projects currently underway include the redevelopment of Nakanoshima into an art, culture, technology and science hub set to include a museum and global communication zone. Furthermore, at Yumeshima, a 390-hectare man-made island near the Port of Osaka, the Osaka government is planning to build an integrated resort, which translates into more employment opportunities. As seen in figure 8, declining vacancy and a reduction in supply since the previous construction cycle in 2009-12 has helped boost office investments in Osaka.

Figure 8: Osaka office vacancy rate vs. Osaka office investment volumes



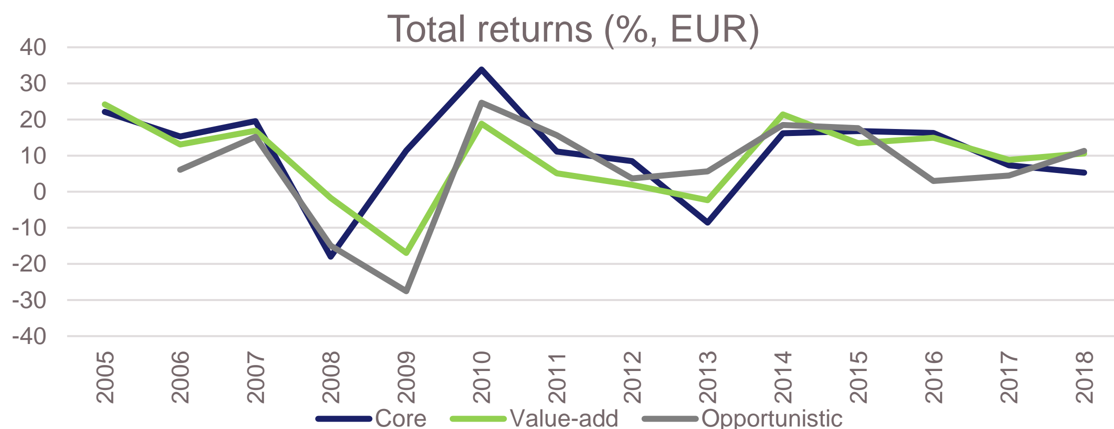
Sources: PMA, RCA

3) A risk-adjusted perspective to core-plus

In a low-return, late-cycle environment, core income returns can be challenging to achieve because spreads are so low and returns extremely tight. Given the investment hurdles to overcome, core evolves to core-plus as investors turn to more accretive investments. Core-plus is a value-add story, where the core is the initial yield on which the property is bought and the plus relates to an immediate increase in the property's value.

Returns of euro-denominated core funds have been declining since 2016, while value-add and opportunistic returns have seen an uptick (figure 9). However, on a risk-adjusted basis, core funds achieve a higher Sharpe ratio (0.86) compared to value-add (0.75) and opportunistic (0.45) funds on a 13-year investment horizon based on Asian Association for investors in Non-listed Real Estate Vehicles (ANREV) data. Both core-plus and value-add can be seen as occupying the middle ground between growth potential and predictable income. They also occupy the middle of the risk-return profile, although in a slightly different way. To help offset this risk, leverage could be used to limit the maximum amount of capital at risk, albeit increasing the percentage risk and return potential on the investment.

Figure 9: ANREV annual total returns fund performance comparison



Source: ANREV

Additionally, the relatively stable income return associated with real estate investment is particularly attractive in a low interest rate environment. Yields on other asset classes remain depressed relative to historical averages and multi-asset portfolio are lower volatility (figure 10).

Figure 10: Income returns component across asset classes in Australia and Japan (Dec 2018)

Sources: Oxford Economics, Nikkei Indices, Market Index, MSCI

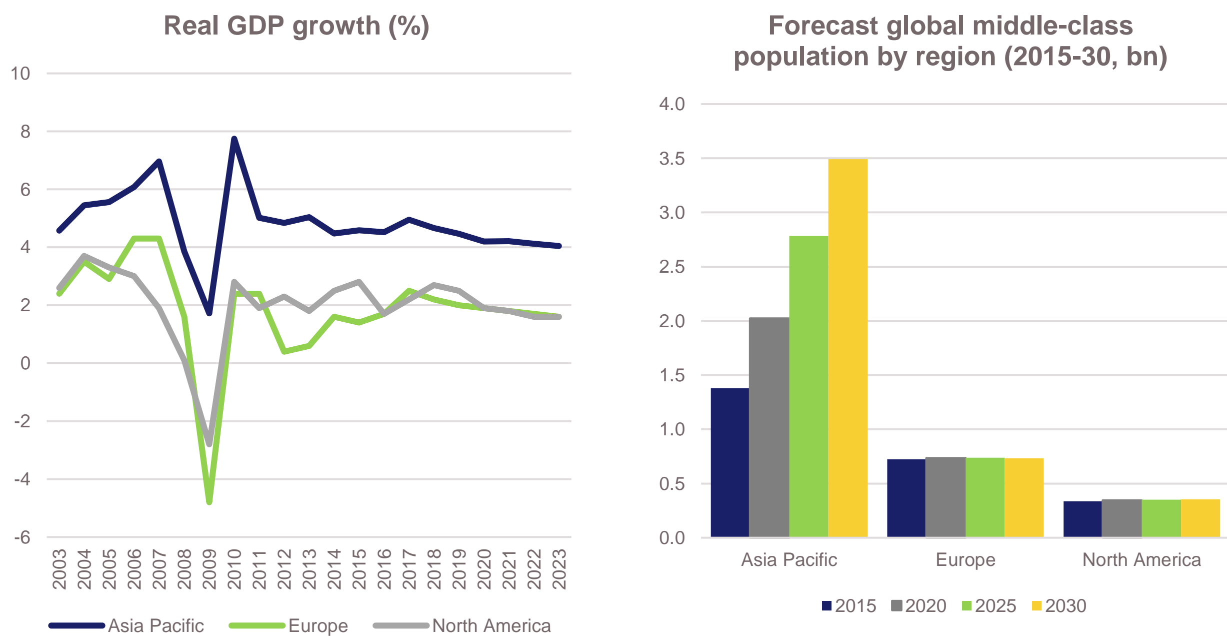
How a core-plus strategy is relevant in Asia-Pacific

Urbanisation trends, the rising middle-class consumer and gradual shifts in output towards the services sector continue to reinforce the attraction of the region, particularly in a subdued global growth environment. Despite slower economic growth in the region, its economy and middle-class population should still outperform the other key regions (figure 11). Underlying fundamentals remain attractive, which may help explain why Asian countries have such a high share of Fortune 500 companies (197 in Asia-Pacific, 134 in North America and 103 in Europe as of July 2019), based on Forbes data.

This has spurred demand for high quality assets as the boundaries of core locations extend and real estate market drivers change, which presents an attractive opportunity to adopt a core-plus strategy. For instance, on the back of higher returns, investors are now more receptive to the idea of investing beyond Central Tokyo in Japan or the Sydney CBD in Australia and are willing to look at other cities or larger metropolitan areas.

The Asia-Pacific region offers significant opportunities for core-plus/value-added investors, supported by limited availability of core product and stronger growth prospects. Limited core opportunities mean investors looking to gain exposure to a particular market may only be able to do so through higher risk strategies, including build to core or manage to core. The scarcity of core products available for investment reflects either the high percentage of owner-occupiers in a given market or the prevalence of large estates controlled by dominant single owners (such as real estate investment trusts).

Figure 11: GDP and global middle-class population forecasts by region

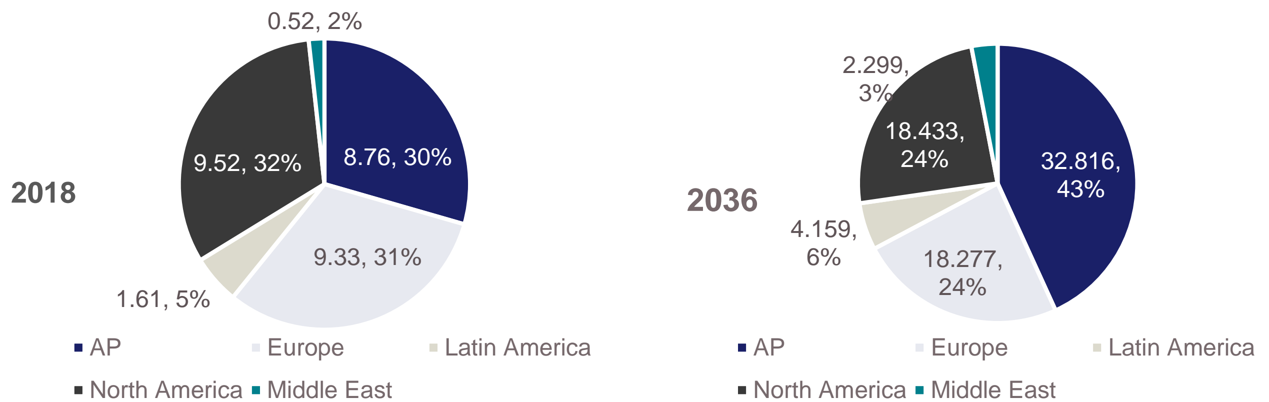


Sources: Statista, IMF

Improving market transparency and a maturing investment universe helps to boost the institutionalised investable universe in the region. Based on PGIM estimates, Asia-Pacific's share of the global investable universe is set to rise to 43% in 2036 from 30% in 2018, overtaking the rest of the other regions (figure 12). This strong growth can only be beneficial for real estate investors, as it improves the depth of stock and investment value.

As global markets face more uncertainties (e.g., Brexit and the adoption of a protectionist stance by the US), Asian markets are set to benefit from stronger intraregional trade ties. It is consequently an apt time to consider investing in Asia. Despite concerns about excessive pricing and the prolonged period of excessively low interest rates that boosted property prices in Asia-Pacific, according to CBRE there remain pockets of opportunities to either acquire assets – albeit with lower return expectations – or to create or adopt a core-plus/value-add approach. We recommend that investors capitalise on local property dynamics in order to rebalance their portfolio and review their hurdle rate of returns in a new-normal growth environment.

Figure 12: Estimated global investable universe by region (USD tn, 2018)



Source: PGIM

Positioning for growth

While the focus on income is crucial, it is equally important to target growth. Asia-Pacific is a dynamic region comprising many markets at different points in the property cycle and offers significant structural and cyclical opportunities. Growth can be achieved via several channels:

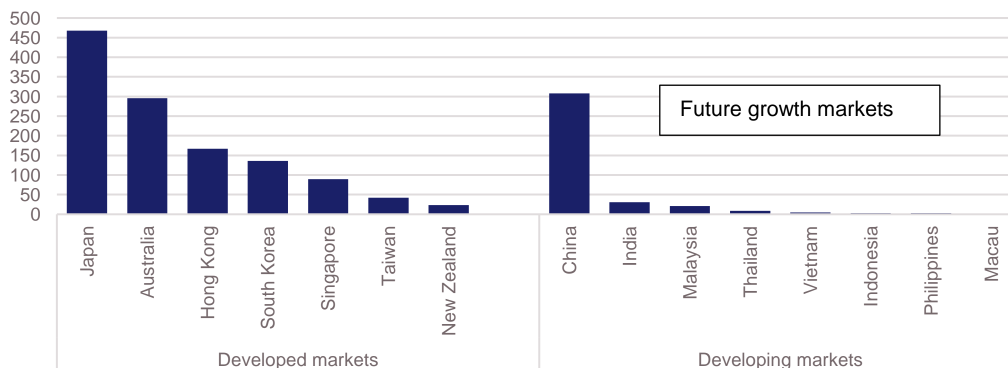
- targeting future growth markets such as South East Asian markets benefitting from secular themes such as urbanisation and favourable demographics
- targeting growth areas such as extensions of CBDs or emerging business/ technology districts that benefit from infrastructure improvements or other secular trends
- mispricing/arbitrage opportunities as well as identifying late/early recovery markets

Real estate targets

We recommend investors focus on Australia, Japan and Singapore, the most liquid and developed markets in the region where risks are lower and transparency is higher. These markets have strong structural fundamentals supporting different market opportunities underpinned by region-wide megatrends. In particular, the size and depth of Australia's and Japan's respective invested universes, high liquidity in terms of transactions and wide yield spreads over 10-year government bonds means these markets are suited to anchor a core-plus portfolio as income stabilisers.

At the same time, we are also on the lookout for mispricing opportunities and potential core-plus/value-add deals in South Korea, which remains as the third most liquid developed market after Australia and Japan (figure 13).

Figure 13: Asia-Pacific transaction volumes of income-producing assets (USD bn, 2007-H1 2019)



Source: RCA

Investment themes

Early-recovery markets – Singapore, Brisbane and regional secondary Japanese CBD offices where rents are picking up and expected to grow strongly. Japan residential is also expected to be on a gradual upwards trend thanks to structural fundamentals (inwards migration)

Late-recovery markets – taking on leasing risks with Grade B stock in prime locations such as in Melbourne, Tokyo Grade B offices or Australian logistics

Growth corridors/locations in developed markets supported by secular trends: technology-focused cities such as Pangyo in Seoul, South Korea, and Fukuoka in Japan are showing strong rental growth prospects

Leverage – consider maximising leverage within core+ limits to take advantage of interest rate arbitrage in Japan

Author

Benedict Lai

Global research contacts

Andreas Trumpp
Head of Research, Europe
andreas.trumpp@savillsim.com

Nicole Bångstad
nicole.bangstad@savillsim.com

Judith Fischer
judith.fischer@savillsim.com

Matteo Gralin
matteo.gralin@savillsim.com

Benedict Lai
benedict.lai@savillsim.com

Hamish Smith
hamish.smith@savillsim.com

Savills Investment Management

33 Margaret Street
London W1G 0JD
Tel: +44 (0)20 7877 4700
Fax: +44 (0)20 7877 4777
Email: info@savillsim.com
Web: www.savillsim.com

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