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COVID 19: Revisiting the Asia Pacific economies and real estate markets

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In this tumultuous time, governments around the world have taken steps to contain (or not) the spread of the Coronavirus (COVID-19). The pandemic that started in December 2019 has claimed over 1.1 million lives, infecting over 42 million people, and damaging the global economy. The World Bank forecast a global economic contraction of -5.2% in 2020. We have not seen such drastic global recession since World War II, and income is falling on a per capita basis in the largest fraction of countries since 1870.

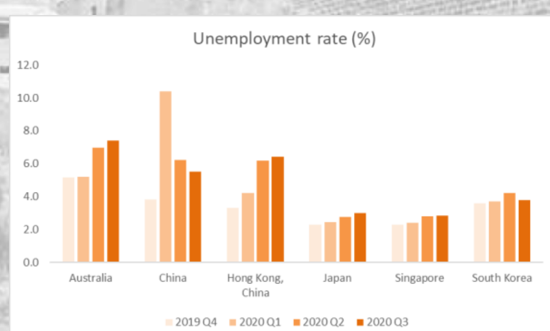
As we head into the one-year mark since the pandemic started, the third wave of infection is sweeping through some countries. There is rising concern that hospitals could be inundated with both seasonal flu and COVID-19 patients as winter approaches in the northern hemisphere. Social distancing rules are tightening for many countries, including Italy, France, Germany, the UK, and Malaysia, which registered a surge in infection. The economic recovery is no longer a "V" that optimists were hoping, but a "U".

The real estate sector, especially on the occupier front, has felt the brunt of the social distancing measures. The impact to date has been somewhat muted compared to what was seen in 2003 during the outbreak of the Severe Acute Respiratory Syndrome (SARS). We expect a further contraction in the market until a vaccine is widely available. Governments, in the meantime, have also stepped up monetary and fiscal support measures to mitigate the impact on businesses and individuals.

Economic fallout

Economic data reported by the key markets in Asia Pacific shows how the effect of the pandemic was felt over the first nine months[1] of 2020, ranging between 9% y-y contraction in Hong Kong in 1Q 2020 to 13% in Singapore in 2Q2020. This contraction was not only due to the massive business closures as a result of stringent social distancing, but also closures of the physical borders to non-residents as early as March in these two cities.

Singapore and Hong Kong are in a recession with both cities contracting between 3-7% y-y in 3Q20 according to official prelim estimates. Given the openness of their economies and reliance on external trade, a sustained recovery will depend on how the pandemic is managed globally. Both cities have setup travel bubble given the low community infection cases. Singapore has also established special travel agreements with other major countries such as Japan, China, Germany and Indonesia in a bid to resume economic activities.

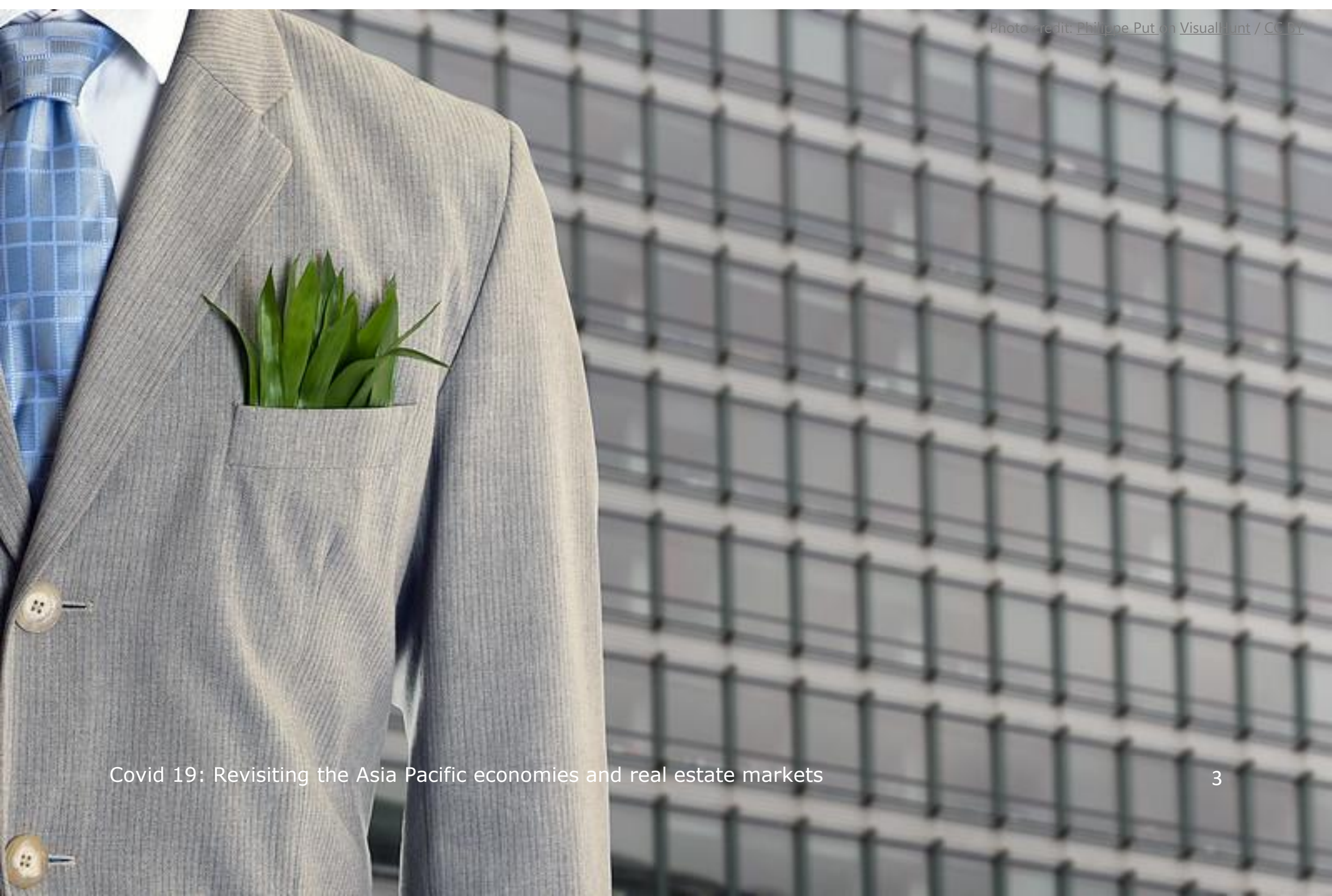


Source: Oxford Economics, ARA Group Research & Strategy, Nov 2020

The employment rate has been hit equally hard, especially in China, where the unemployment rate rose to over 10% in 1Q2020, the highest level since 2000. Weak external demand continues to plague manufacturing activity in China despite the unemployment rate improving to 6% in 2Q2020. Business continuity measures on the back of risk mitigation have prompted many corporates to relocate some of their operations, supporting the demand for industrial assets in neighbouring countries.

Amidst the global economic freeze, some green shoots are appearing. Leading indicators, those that we have been tracking, suggest that some economies may be on the cusp of a recovery. For example, September figures for PMI (manufacturing)[2] in China show it has been in expansion mode (above 50) since May, while it has been expanding in Australia since June. While Japan, South Korea and Singapore are still in contraction (below 50), their PMIs have been improving. Consumers in Japan and South Korea are also more optimistic, as an improvement in the OECD Consumer Confidence Index in August suggests.

Clearly, the jury is still out. The world economy could be heading for further consolidation, depending on how countries are adequately responding to this global health threat, how soon a vaccine is made available, and how effective government fiscal and monetary policies are in mitigating the economic fallout.



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Occupier market in perspective

Property, as a derived demand, will feel the brunt of this economic freeze. Typically, with exogenous events, the market may not register the full impact immediately, and things may continue to unravel several quarters later. The chunkiness of the asset and contractual liabilities in any committed space make it slower for the market to respond to such exogenous events.

Occupier trends, especially those in the commercial markets, expectedly, are feeling the immediate effect of the social distancing measures as retail malls were shut. At the same time, companies sent their employees home to work, right-sized or delayed any new space commitments.

The impact so far has not been as severe as previous crises. Across the core markets we tracked, other than Beijing which registered no decline, the average contraction in demand in Sydney, Melbourne, Brisbane, Perth, Shanghai, Hong Kong and Singapore ranged between -5,000 sqm and -66,000 sqm per quarter since the beginning of the pandemic. The more globally connected the markets, the larger the contraction. Rents have also softened on average between 3% to 22%, as measured from the last peak in each market to 3Q2020. In comparison, according to JLL data, the impact of previous crises on the rents has been as much as 32% in Hong Kong during the SARS outbreak in 2002, and over 60% in Singapore during the Global Financial Crisis in 2007.

However, with no signs of recovery at this point, we reckon occupier demand is likely to deteriorate and coupled with new supply in some markets, these would weigh rents down. Overall consultants expect the rental correction to range from -6 to -20% across these key advanced markets over the near term. Any upside is most likely to come from the technology and logistics firms which have been experiencing strong growth during this pandemic.

Meanwhile, governments and landlords in Asia Pacific have taken steps to mitigate the fallout. The measures include a freeze on office evictions and lease terminations for six months in Australia, direct monetary assistance to support wage costs for businesses in Singapore and Hong Kong, and indirect support through tax and rental cuts, or even exemption, in the case of SMEs that lease state-owned assets in China.

As businesses are gradually returning, the level of security and hygiene is of utmost concern to any occupier. Landlords have expanded their cleaning regime, provided temperature checks for all visitors to their premises, and implemented contact tracing. In the longer term, we envisage landlords to adapt office designs as the workforce becomes more agile and overall well-being moves up on the list.

Investment during a pandemonium

On the capital market front, according to data from Real Capital Analytics, the volume of investment activity globally has softened by 51%, reportedly the worst quarterly level since 2Q2009, with retail and hotel sectors emerging as the most significant causalities. Unsurprising to many, the investment volume in Asia Pacific has contracted for two consecutive quarters, given that the region was the first to be hit by the pandemic in December 2019. Despite that, major global cities in Asia Pacific, i.e. Tokyo, Shanghai, Seoul, Beijing, Sydney, Osaka and Hong Kong, continue to remain among the 30 most active metropolitan areas globally.

Given the underlying strength of the Asia Pacific economies, as discussed in an earlier article[3], their defensive nature has continued to attract substantial interregional capital[4] into the Asia Pacific real estate markets. The strength of the regional and domestic capital markets, together with the depth of these property markets, has fueled investment activities. According to RCA, cross border funds[5] contributed to almost 50% of investment deals in Asia Pacific in 1H2020. Overall, Japan has the lion's share of the interregional capital, especially those originating from the US. China and Australia received a substantial portion of intraregional capital[6]. Based on our analysis of RCA's data, the levels of cross border activity (from January to Sep) in Australia, China and Japan, as well as Singapore, continue to exceed their five-year (2015-2019) averages, reflecting healthy foreign investor confidence in these markets.

Intraregional and domestic capital has propelled Shanghai to the second spot after Tokyo and ahead of Seoul, in RCA's ranking of Asia Pacific metropolitan areas, in terms of investment volume in 1H2020. Tokyo has always maintained a soft spot in many institutional investors' hearts, given the size and liquidity of its real estate market. Shanghai, on the other hand, has surprised many market observers by bucking the regional trends. On a y-y basis, the investment volume in Shanghai in 1H2020 has barely been affected by the pandemic compared to other major Asia financial markets such as Hong Kong and Singapore.

Arguably, the size of the available capital has supported a large part of this investment trend in Asia Pacific in recent years. In fact, according to Preqin data, an average of USD 33 billion of dry powder was available per year between 2015 and 2019. As of August 2020, some USD 36 billion worth of dry capital is yet to be deployed in the region. Echoing this trend, a separate survey by PERE earlier this year showed that over 78% of institutional investors expect to increase their exposure to Asia Pacific markets over the next two years.

Despite the abundance of capital, the downside risk remains in the leasing market. This uncertainty is likely to pose a drag on the rental outlook in short- to medium-term. Without any foreseeable vaccine insight, travel restrictions are expected to remain in place in many countries, limiting cross border transactions during this time. As governments relax their monetary policies to support the local economies, yields of short-term government bonds have softened to under 1% in Australia and Singapore, and negative in Japan. With heightened business risks, firms are also likely to adopt asset-light strategies, and some may consider offloading their real estate.

The confluence of these downside factors outweighs the abundance and low cost of funds, and this could lead to further yield expansion in Hong Kong, and possibly Australia, as redemption pressure rises among open-ended funds, according to CBRE.

Investors are also likely to gravitate towards defensive play, investing in favourable structural trends such as consumption-driven logistics assets and technology-linked data centres, as well as real estate credit. Built-to-rent residential and lifestyle homes for retirees are also gaining traction on the back of recent population trends.

Silver lining

In a nutshell, with no clear end in sight for the current pandemic, social distancing measures are likely to remain in place albeit intermittently as new clusters rise and fade. Meanwhile, investments are expected to stay moderate as travel restrictions affect cross border transactions, although domestic demand remains resilient. Investment strategies are likely to be more defensive, focusing around structural trends such as consumption, technology, and lifestyle-related assets.

Endnotes

[1] 3Q20 data are preliminary estimates for some markets

[2] PMI data by HIS Markit, https://ihsmarkit.com/products/pmi.html

[3] The Asia Pacific region amidst COVID-19, May/June 2020, IPE, https://hub.ipe.com/asset-manager/ara-private-funds-real-estate/the-asia-pacific-region-amidst-covid-19/10045544.supplierarticle?adredir=1

[4] Funds that originate from outside the region, in this case Asia Pacific

[5] Intraregional and interregional capital

[6] Funds that originate from within the region but not from the destination country where the capital is invested

About ARA Asset Management Limited

ARA Asset Management Limited (ARA or the Group) is a leading APAC real assets fund manager with a global reach. With S$87 billion in gross assets under management as at 31 December 2019, ARA manages listed and unlisted real estate investment trusts (REITs) and private real estate and infrastructure funds in 28 countries. As part of its investor-operator philosophy, ARA also operates a real estate management services division with local teams to manage its assets worldwide.

ARA's multi-platform, multi-product global fund management strategy, combined with its dedicated teams with in-depth local knowledge and expertise, enables the Group to offer enduring value to investors. Built on a foundation of strong corporate governance and business integrity, ARA counts some of the world's largest pension funds, sovereign wealth funds, financial institutions, endowments and family offices as its investors.

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Dr Chua Yang Liang heads up the Research & Strategy team at ARA Asset Management. He is responsible for monitoring the economic and property markets across Asia Pacific, and providing strategic advisory to the Firm.

Dr Chua has almost 20 years' experience in the research and planning-related field. His most recent stint was with JLL where he headed their research teams across South-East Asia.

Trained as an urban planner, Dr Chua brings to the Firm a different perspective to property market research and he publishes original papers covering property market updates as well as investment and property related matters.

Dr Chua obtained his doctorate and Masters in City Planning from the University of Pennsylvania, USA. He has a Bachelor of Science (Estate Management) First Class Honours, from the National University of Singapore.