PGIM REAL ESTATE

INVESTMENT RESEARCH

FIRST IN, FIRST OUT: ASIA PACIFIC TO LEAD A GLOBAL RECOVERY

December 2020

Introduction

The outbreak of COVID-19 was an unexpected headwind in the early months of 2020. The abrupt deterioration of the economic environment due to strict travel restrictions and social distancing measures put an end to the long real estate cycle in Asia Pacific. Market data for the last two quarters shows rising vacancy and declining rents across the region, most notably in retail and hotels.

Having already experienced the SARS and H1N1 epidemics in 2003 and 2009, respectively, Asia Pacific countries were comparatively better prepared to deal with a significant public health crisis and have been managing the COVID-19 pandemic effectively so far. Second waves of infections were brought under control within a couple of weeks in all major Asia Pacific countries – and, for this last quarter of 2020, most Asia Pacific economies are expecting further normalization of economic and social activity.

A sustainable recovery from the current crisis will depend critically on the pandemic being brought under control. In this respect, Asia Pacific has some advantages compared with other regions and its economies are well placed to recover earlier and stronger than the rest of the world. While short-term uncertainty remains, investors should start to position themselves to benefit from a real estate recovery cycle in the region.

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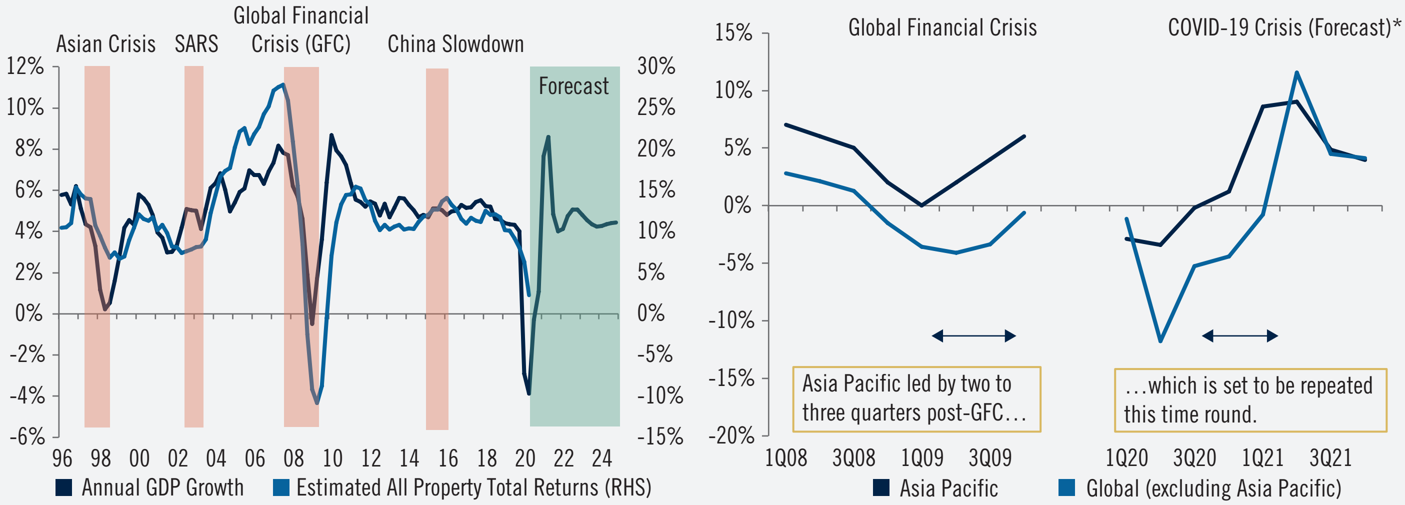
Evidence from Recent Downturns

It is clear that the impact of the COVID-19 pandemic on the Asia Pacific and global economy has been severe. In the first half of the year, the Asia Pacific economy showed its deepest annualized decline in decades (exhibit 1). However, evidence from previous downturns suggests that Asia Pacific economies often rebound swiftly following crises.

During the Asian financial crisis in 1997 and 1998, economic growth recovered well over the subsequent two years. Furthermore, during the global financial crisis in 2008 and 2009, which disproportionately affected Europe and the United States, the Asia Pacific economy recovered ahead of the global economy by a couple of quarters (exhibit 1). This pattern of recovery momentum is set to repeat this time.

Exhibit 1: Asia Pacific Economic Growth and Real Estate Returns

Asia Pacific GDP Growth and Real Estate Total Returns (%, p.a.) **GDP Growth: Global and Asia Pacific** (%, p.a.)



Sources: JLL, Oxford Economics, PGIM Real Estate. Note: * Forecasts are as of December 2020.

Following the region's major economies starting to ease social distancing measures in May and their ability so far to control second waves of infections without national lockdowns, the major Asian economies showed encouraging signs of recovery in the third quarter.

Perhaps the most notable recovery is in China, where activity in most business and economic sectors has grown to above pre-pandemic levels. Developed Asia Pacific economies such as Australia, Singapore and South Korea are also expecting quarter-on-quarter growth, suggesting that the worst of the economic slump is probably over for these economies.

Containing more than half of the world's middle class population, according to World Bank data, Asia Pacific will continue to benefit from structural growth of consumer spending and further economic integration among the regional economies. Intra-regional trade had risen to 56% of total exports by the end of 2019 and among the major economies of Australia, Hong Kong, Singapore, South Korea and Japan, nearly 70% of exports are to other Asian economies[1].

The structural rise of economic integration also reflects in the growth of intra-regional investment and deepening financial links between Asia Pacific economies. Intra-regional capital flows increased from 40% in 2009 to 55% in 2019, according to UN data. The recently signed free trade agreement between fifteen countries in the Asia Pacific region – the Regional Comprehensive Economic Partnership (RCEP) – is expected to broaden economic engagement and facilitate the expansion of regional trade in the coming years. With the dynamic drivers of economic growth, we expect Asia Pacific economies to continue to recover, decoupling from the economic weakness that is expected to remain in other regions.

With close links to economic performance (exhibit 1), real estate markets are benefitting from an improved economic environment. So far, despite the apparent pain in retail, hotel and office occupier markets, significant policy responses from Asia Pacific governments — notably in Australia, China, Japan, South Korea and Singapore, where average stimulus spending amounted to more than 10% of annual GDP — have provided significant support to occupier and investor confidence.

[1] Source: CEIC

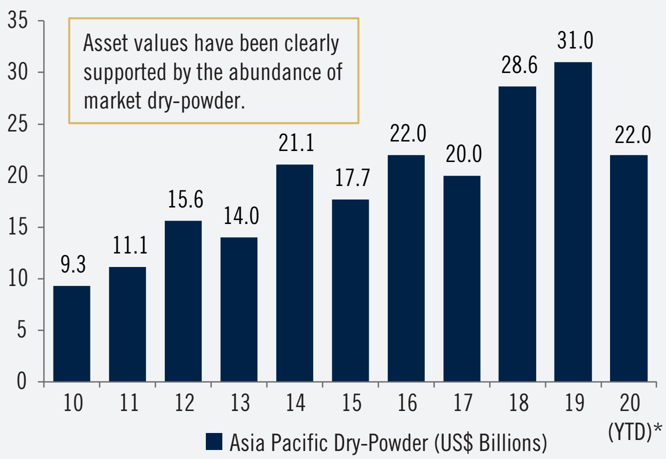
Just as the downturn is sharp and severe, the recovery that follows will likely be strong – particularly when the cause of the downturn was an exogenous shock in the form of a global health crisis – and, following economic recovery, the regional real estate market cycle is expected to turn a corner in the next twelve months.

Abundance of Capital Inflows to Support the Recovery Momentum

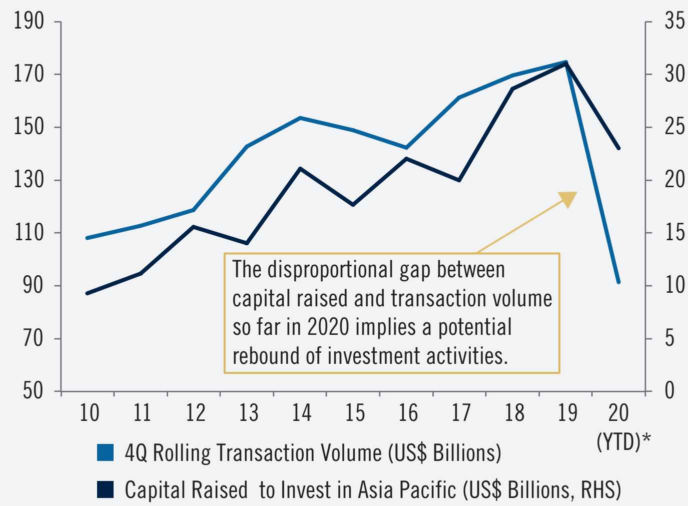
In recent years, as the market cycle grew longer, high prices and lack of investment opportunities were frequently cited as the biggest challenges for investors in deploying their capital in the region. The lack of motivated sellers in a highly competitive environment has fostered yield compression across major sectors.

Exhibit 2: Capital Raised to Invest in Asia Pacific

Capital Raised by Real Estate Funds to Invest In Asia Pacific (US$ Billions)



Capital Raised and Real Estate Transaction Volumes (US$ Billions)



* Year-to-date (YTD) data is up to October 2020.
Sources: RCA, Preqin, PGIM Real Estate. As of December 2020.

Indeed, there is ample capital waiting to be deployed in Asia Pacific with capital inflows to Asia real estate funds breaking records over the past two years, and more than US$31 billion raised in 2019 alone. Even during the pandemic, global investors were showing strong commitment to the region with nearly US$22 billion of new capital registered so far this year (exhibit 2).

The abundance of capital waiting to invest will undoubtedly support the resilience of real estate pricing and boost recovery momentum once leasing market fundamentals start to stabilize. The typically positive correlation between capital raised and investment activity, as shown in exhibit 2, suggests that the currently low transaction volumes - due to the impact of travel restrictions and short-term uncertainty - could rebound robustly when a recovery arrives.

History demonstrates that a downturn can also be a period of opportunity — particularly for investors who can look beyond the short-term uncertainty and focus on the longer term outlook.

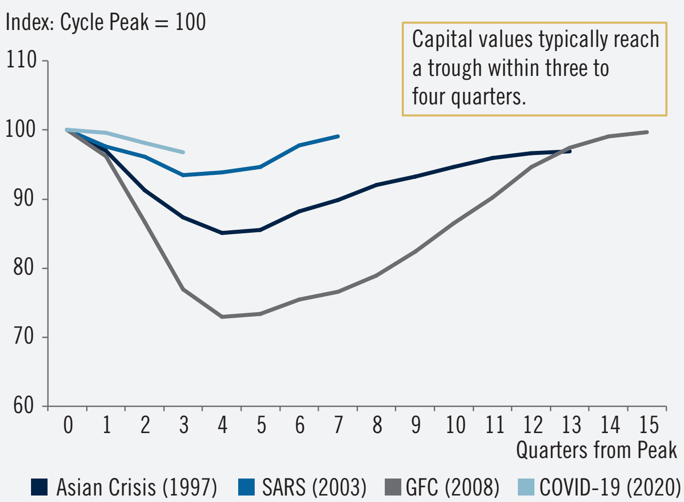
Tapping Cyclical Investment Opportunities

Opportunities arising from downturns are typically diverse, depending on the presence of ongoing structural themes, the extent of price adjustment, and the fundamental dynamics of individual markets.

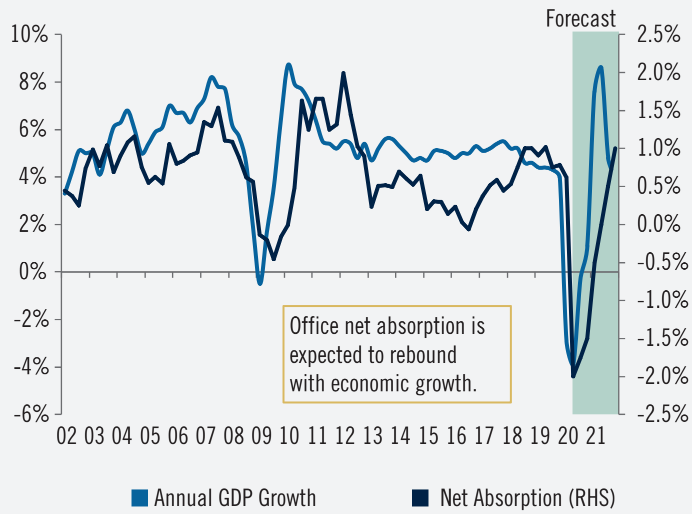
In addition to the structural opportunities in sectors such as logistics and data centers, which are benefitting from the accelerated growth of the digital economy, cyclical opportunities are emerging in selective office markets which are currently facing drawbacks but offering solid prospects in the longer term.

Exhibit 3: Office Capital Value Cycles and Net Absorption

Asia Pacific Office Capital Value Index by Downturn



GDP Growth and Office Net Absorption (% Stock, 4Q Rolling)



Sources: JLL, PGIM Real Estate. As of December 2020.

As a growth sector with favorable fundamentals before the pandemic, the office sector is, however, going through a down cycle with most markets currently experiencing rising vacancy and declining rents.

So far, office asset values have held up relatively well, supporting a confidence that the pandemic will cause less severe capital loss in comparison to the previous downturns. Historical evidence suggests an average of three to four quarters of capital value declines before the market starts to stabilize and turn for a recovery as shown in the left-hand side chart of exhibit 3.

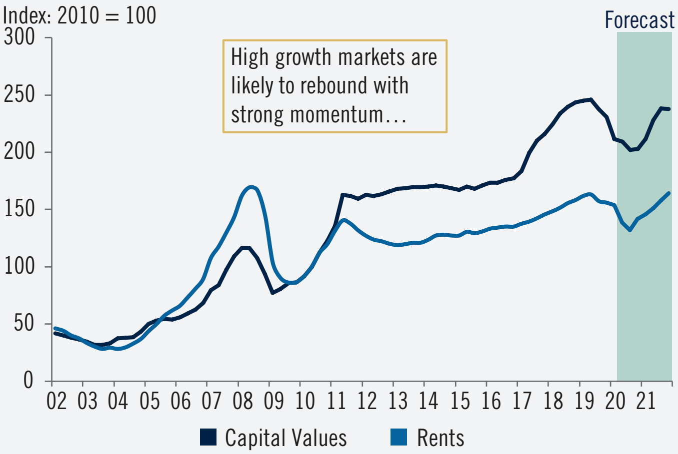
Despite the potential impact of increased flexible working arrangements on the demand for office space in the longer term, we expect economic recovery to lead to a cyclical rebound of office demand as employment markets start to grow again (exhibit 3). However, the recovery momentum is expected to be diverse across markets.

A group of high growth markets including Hong Kong, Shanghai, Singapore, and Sydney are expected to start the recovery cycle earlier and with stronger momentum than other office markets in the region. Having high exposure to the global economy, and therefore facing higher volatility during a global downturn, these high growth markets grew more than twice as fast as other markets in the years after the global financial crisis. As the region starts to recover from the pandemic, these markets are, once again, set to outperform (exhibit 4).

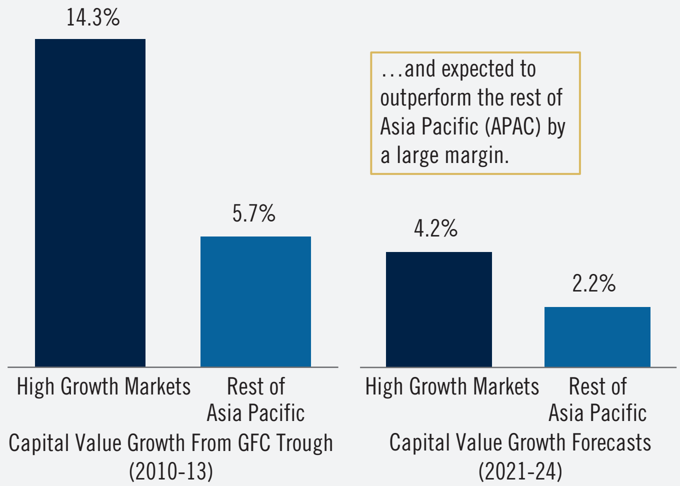
Among the high growth markets, Singapore looks best placed to enjoy a strong cyclical recovery, while prospects in Hong Kong may be hampered by political concerns in the near-term. However, as gateway cities to the Asia Pacific economic region, all four markets offer strong growth prospects in the longer term – and this pandemic downturn could provide great opportunities to enter those markets.

Exhibit 4: Cyclical Opportunities in High Growth Markets

High Growth* Office Market Capital Value and Rental Index



Prime Office Capital Value Growth (%, p.a.)



* High growth markets include Hong Kong, Shanghai, Singapore and Sydney. Rest of APAC includes major markets in developed Asia Pacific economies and China.
Sources: JLL, PGIM Real Estate. As of December 2020.

Concluding Remarks

Asia Pacific is set to lead a global recovery from the pandemic downturn. While real estate and investment markets are under near-term pressure, opportunities are emerging in the form of structural growth underpinning the long-term outlook for the logistics sector or the defensiveness of the residential sector.

The biggest set of opportunities in a downturn is, however, cyclical. Pressures from a downcycle could potentially shake loose values in the markets – such as high growth offices - that are highly competitive in normal market conditions.

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