Real Estate Research

January 2024

Asia Pacific Real Estate Strategic Outlook

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IN A NUTSHELL

- Elevated interest rates in Asia Pacific continued to hamper real estate investment volumes, with asset repricing trends more advanced compared to six months ago. We expect the price correction trend to continue, with cap rates hitting a peak this year before easing in 2025 as monetary conditions ease.
- Our Houseview investment themes include the Residential Built-to-Rent sector in Australia with rental growth underpinned by the housing shortage; Debt strategies in South Korea with opportunities for alternative capital to ease credit market constraints; and portfolio optimization in Japan to sell non-strategic assets and recycle capital.
- Investors may also consider regional value-add opportunities such as tactical investments in repriced office and logistics assets and asset repositioning strategies, while selective investments in higher risk operational real estate and emerging markets could drive higher returns.

1 / Economic Update

Economic Conditions:

Having crossed over from the year 2023, investors looking at Asia Pacific might experience a sense of Déjà vu while starting off the year 2024 – uncertainty over economic growth prospects amid weakening global trade notwithstanding the normalization of supply chains, disinflation at work leading to ranging expectations over central bank policy movements and interest rate outlook. Our latest CIO views expect Asia' economic outlook to be uneven, with China and Japan's growth in 2024 to slow to 4.7% and 1.0% respectively, while other developed economies of Australia, South Korea and Singapore could see mild growth capped below 2.5%.

Within Asia Pacific, country-specific themes could influence the investment climate. For China, geopolitical tensions, property debt risks and slowing economic activity pose negative spillover risks to the region, given China's position as the top export destination for many of its neighbouring countries. In Japan, the key question is whether the country can see wage-led inflation finally gather strength, which could in turn lead to the normalization of The Bank of Japan's interest rate policy and drive yen currency movements. In Australia, inflation readings remain elevated relative to other economies in the region while consumption spending appears to have slowed, leading to speculation whether the Reserve Bank of Australia is done with its interest rate hikes.

With central bank policy rates outside China and Japan at multi-year peak levels, real estate financing costs remain elevated, with senior loan rates in Australia, South Korea and Singapore staying at 5% to 6% levels. We continue to see lenders' preferences gravitating towards higher quality assets in good locations while remaining more cautious on lower quality assets and development projects in secondary locations. The lack of development financing and higher debt returns coupled with supply constraints presents investment opportunities which we will elaborate further in subsequent sections.

2 / Real Estate Outlook

Office:

The office sector remains a conundrum for investors globally, with many US and European based investors still reeling from their experiences of elevated vacancies and headlines-making price corrections in their domestic markets. Higher office attendance levels in Asia Pacific remain a key distinction factor versus North America and Europe. Current office utilization rates in Tokyo, Seoul, Singapore and China have hit at least 80-90% of their average pre-pandemic levels respectively, much more favourable than the 50% level in the U.S. Australia is the exception with lower albeit improving attendance levels.

Overall office leasing activity in the region has been mixed, influenced by uncertainties in the macro-economic outlook, as occupiers generally remain cautious while taking longer to conclude leasing deals. China and Hong Kong have seen weak leasing volumes due to poor business sentiment, near term supply pressures and rising vacancies. Japan saw a gradual recovery of pent-up office leasing demand from relocation requirements and healthy service industries, yet the office vacancy rate remained above 6% on the back of strong incoming supply, while macroeconomic headwinds cut short the office rental recovery in Singapore. Office vacancy in Australia remains elevated in the 12-14% range though incentives appear to be near a peak. Seoul is the notable outperformer in the region benefiting from strong rental growth underpinned by healthy leasing demand driven by the technology industry as vacancy remain at record lows.

Notwithstanding the overall weak picture, the divergence across office segments remains intact with tenant preferences clearly inclined towards high-quality developments with green credentials, highly efficient floor layouts and upgraded building facilities, with these developments outperforming older commodity buildings in secondary locations in terms of leasing volume and rental growth. Such flight-to-quality trends remain non-uniform across the region, being more evident in Australia and Singapore, while less so as in China and Japan facing strong pressures from new builds.

Industrial:

Prime logistics assets benefited from strong rental performance, particularly in markets with tight supply such as Australia and Singapore where a lack of available modern warehouse space drove prime vacancy rates below 2%. Structural post-COVID tailwinds of rising e-commerce retailing trends remain intact, with resilient occupier demand from third-party logistics providers (3PLs) and omnichannel retailers supporting take-up and occupancy levels, particularly in locations with good transport accessibility and low availability of prime assets.

Rising construction costs are likely to negatively impact the level of future supply across the region, while in Japan a lack of truck drivers underpins more space demand in infill locations. Other long-term structural factors remain at play: post-pandemic diversification of supply chains within Asia Pacific, increased nearshoring practices, shifts from just-in-time to just-in-case inventory management, upgrading demand away from obsolete owner occupation stock towards higher-quality leased warehousing suited for increased automation demand – all while a structural undersupply of modern facilities in the region persists. As such, we retain a constructive outlook on logistics with rental growth expectations at around 3% per annum and above across in our core location calls.

Retail:

The APAC retail sector has generally benefited from the rebound in international tourism as well as post pandemic consumption boost driving retail sales, yet the recovery remains uneven across the region. High-street retail locations with a significant exposure to inbound tourism in Tokyo, Seoul and Singapore have benefited from modest rental growth along with the recovery in leasing sentiment. On the other hand, slowing growth in discretionary spending in Australia continued to weigh on leasing with incentives remaining at record high levels, while retail rents in China have been on the decline as the recovery in domestic consumption remains uncertain.

While the retail downturn story has run its course over the past several years and rents appear to have either bottomed or near bottoming out in many places, the sector remains out of favour with investors questioning the long-term demand drivers for retail space. We remain in the same camp, that while rents and occupancy could be stabilizing, retail assets with limited rental upside yet exposed to the threat of rising ecommerce retail and shifts in discretionary spending do not seem attractive.

Residential:

The Living sector in Asia Pacific continues to gain momentum, as investors look to diversify away from the traditional main office and retail sectors, while residential assets provide more resilient cashflows closely linked to inflation and fundamental housing needs rather than cyclical economic factors. Japan's mature multifamily sector continues to attract the bulk of institutional capital inflows looking to benefit from the ongoing urbanization and household formation around major city centres. At the same time, rising record-high prices of for-sale condominiums continue to drive first-time home buyers towards house rentals, while larger units remain popular particularly for households on hybrid work arrangements.

Increasingly, investors are looking into Built-to-Rent residential models across the region, particularly in Australia and China. Australia has experienced some of the strongest housing price pressures in the region, with nationwide housing values having climbed 31% since early 2020[1] and hitting record highs in some capital cities. High interest rates contributed to the worsening owner-occupied housing affordability, driving unabated rental demand while rising construction costs and high interest rates have exacerbated the lack of new supply. In addition, fundamental growth drivers of high immigration numbers and relative rental affordability should help underpin rental growth over the coming years.

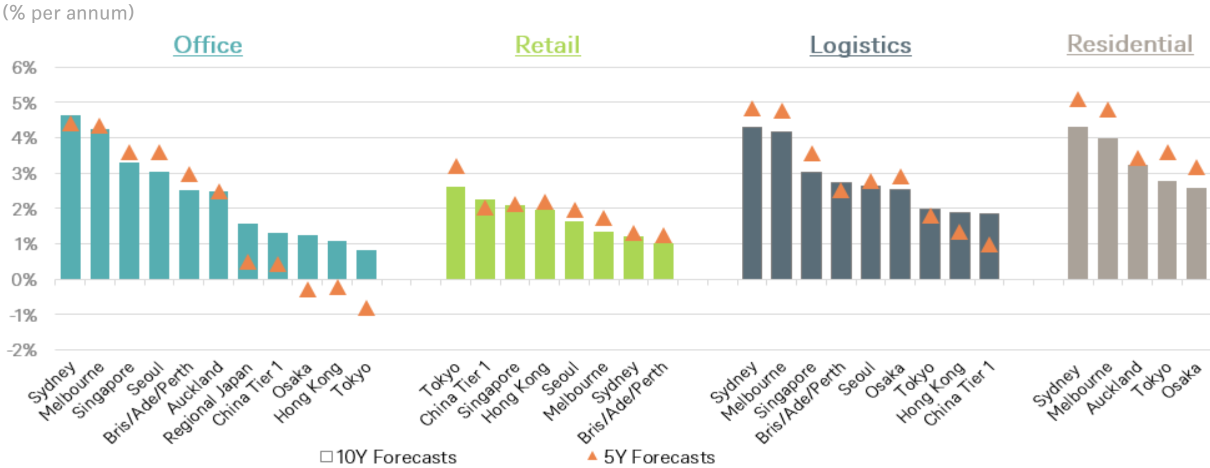
Hospitality: Based on IATA figures, air passenger travel in Asia Pacific continued its recovery, reaching 90% of 2019 levels in October 2023. Meanwhile, APAC hotel occupancy rates during the first 8 months of 2023 have reached about 90%-95% of 2019 levels, with RevPAR in Singapore, Hong Kong, Sydney and Tokyo estimated to have grown by 11%-18% in 2023[2]. With Japan a major beneficiary of the tourism rebound, the upscale limited-service hotel in key Japanese regional markets could be highly sought after by investors given rising demand for upscale accommodation from travelers and higher profitability.

Rental Outlook

Our updated long-term rental growth forecasts are presented below. We believe that the residential markets (multi-family, built-to-rent) in certain locations such as Australia provide strong rental growth opportunities, particularly over the next few years. We also expect sustained growth in logistics rents, led by key logistics hubs in Australia, Singapore and regional cities on North Asia, along with rents in select office markets.

Exhibit 1: Rental Growth Forecasts (2024-2033F)

(% per annum)



Note: Rents shown are on net effective basis after incentives. There is no guarantee the forecasts shown will materialize.
Source: DWS. As of January 2024.

[1] CoreLogic HVI Index, December 2023
[2] STR Gobal, November 2023

3 / Investment Trends

Capital Flows

Based on MSCI data, transaction volume for income-producing assets in Asia Pacific fell 28% year-on-year to US$28 billion in the third quarter of 2023 (rolling 12-month: -37%), the lowest in 13 years since 2010. Investment flows remains concentrated in the core markets of China, Japan, Australia, and South Korea. While domestic investors remain the dominant source of capital, the share of regional cross-border investors have climbed from the pandemic lows of 11% to a near record high of 18%, driven by investors from Singapore and Hong Kong. Notably cross-regional investors from U.S and Europe have remained largely on the sidelines, with their share falling to a near record low of 10%.

Pricing Trends

The first half of 2023 marked a period where sellers with strong holding power refused to budge from their asking prices despite rapid increases in interest rates. Investors remained largely on the sidelines resulting in limited transaction activity and pricing movements were hardly noteworthy. However, while transaction volumes remain light in the second half of 2023, the price discovery process has picked up pace as more transactions reflected downward pricing. Market participants should heed caution in interpreting regional trends though, as the pricing trend varies by country with Japan the notable exception having seen little to nil price correction.

We estimate that prime yields in Australia and South Korea have expanded by between 80 to 140 basis points (bps) over the past two years till end of 2023, reflecting cumulative price declines of up to 15%. For instance, a few prime office assets in Sydney's CBD were transacted at up to 17% below their 2022 book values, reflecting net yields of 6% compared to the sub 5% yields the same buildings would have commanded 18 to 24 months ago. Meanwhile, prime assets in Singapore have experienced price declines of a lower magnitude as the emergence of private capital partly offset the withdrawal of institutional buyers.

As a caveat, forecasting was never an easy process to begin with – this challenge is compounded by the elevated uncertainty of movements in regional monetary policies and risk-free government bond yields (Exhibit 3), on top of the usual shifts in the macro-economic and real estate environment. Based on current market expectations of interest rates remaining high at least for the foreseeable future before inflation fears subside, we anticipate that any reversal of the rising cap rate cycle might be delayed until mid to late 2024, with investment risk appetite picking up again as interest rate headwinds subside. The repricing cycle is likely approaching the advanced stages, though we still expect to see yield expanding by a further 15 to 30 bps leading to additional price depreciation for at least the first half of 2024, while pricing could potentially bottom out by late 2024. On the other hand, the higher interest rate environment has significantly enhanced the appeal of private real estate debt for both stabilized assets and construction loans which offers high-yielding returns with additional downside protection.

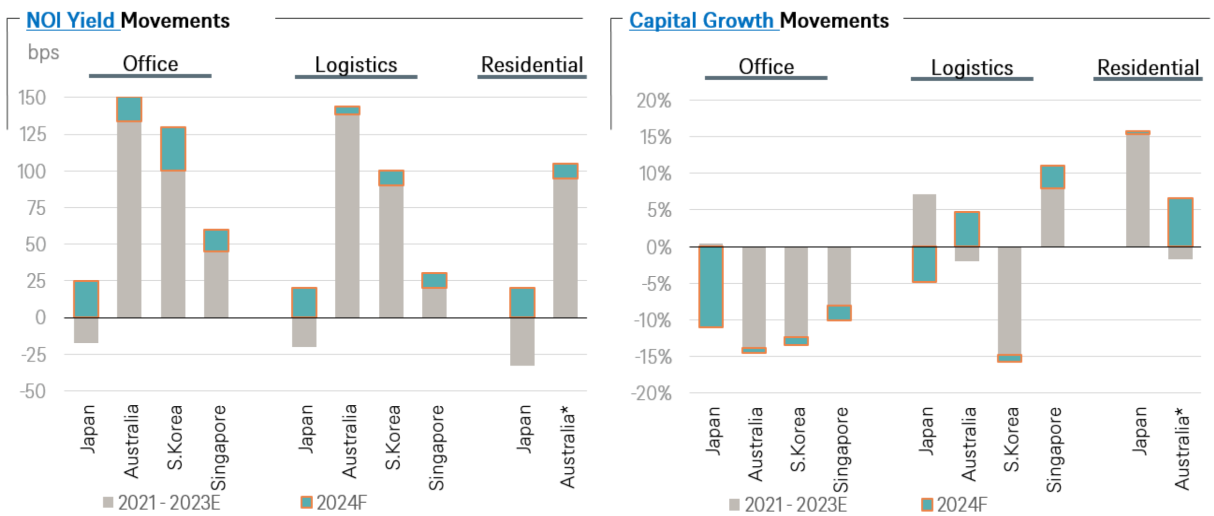
Japan have been a major beneficiary of capital inflows and cap rate compression owing to its negative-interest rate policy, but increasingly this investment thesis is being questioned as higher inflationary pressures and a significantly weakened yen currency drive the prospects of interest rate normalization. Coupled with rising supply pressures and weakening office rents, we expect Japan assets to finally experience a modest price correction in 2024, led by Tokyo and Osaka which have weaker demand-supply dynamics.

From a sector perspective, while office assets have been more vulnerable to pricing adjustments, the industrial sector has shown more resilience in this cycle, driven by strong rental growth which helped offset rising yields. We believe logistics prices should be close to stabilizing with potential for pricing upside, although long-WALE warehouses in secondary locations with significant pipeline supply are more vulnerable to further price corrections compared to institutional-grade warehouses in transport nodes with low vacancy levels.

The institutional residential sector is also likely to benefit from potential pricing upside due to strong demand drivers and continued rental growth, particularly for Australia where the urgency for more rental housing stock and favourable tax changes (see Section 5) is expected to drive the institutionalization of the BTR sector.

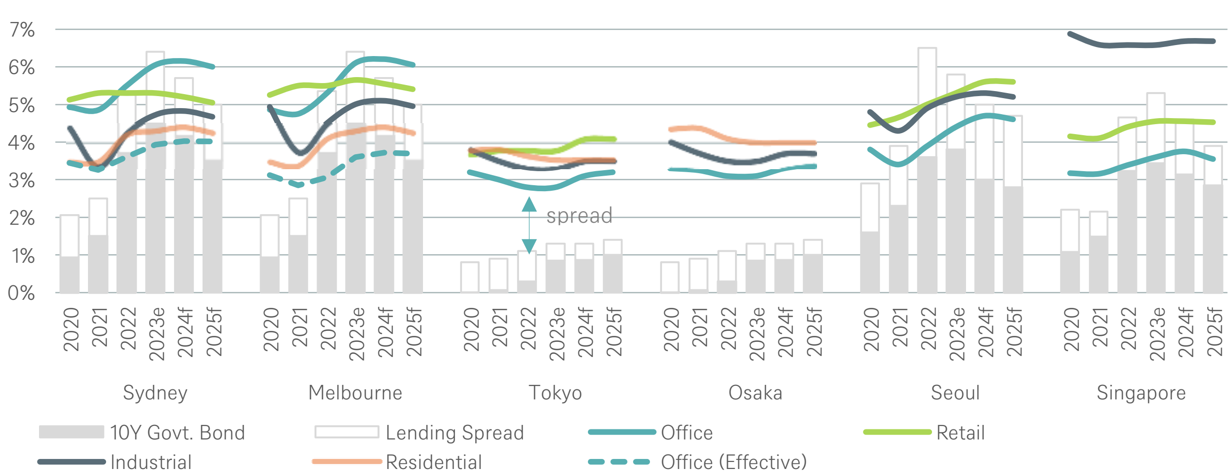
At the same time, given the rising focus by investors on quality assets with ESG trends in mind, we believe owners of non-prime, lower-quality assets with high capital expenditure requirements will increasingly look towards divestment and recycle capital into the prime space. This should continue to drive the divergence in pricing trends with weaker performance in lower quality assets against prime assets.

Exhibit 2: NOI Yield and Capital Value Changes since Q4 2021



*2021-2023 figures for Private Rented Market / Built-to-sell market E=Estimate, F=Forecast. There is no guarantee the forecasts shown will materialize.
Source: DWS. As of January 2024.

Exhibit 3: NOI Yields vs Bond Yields



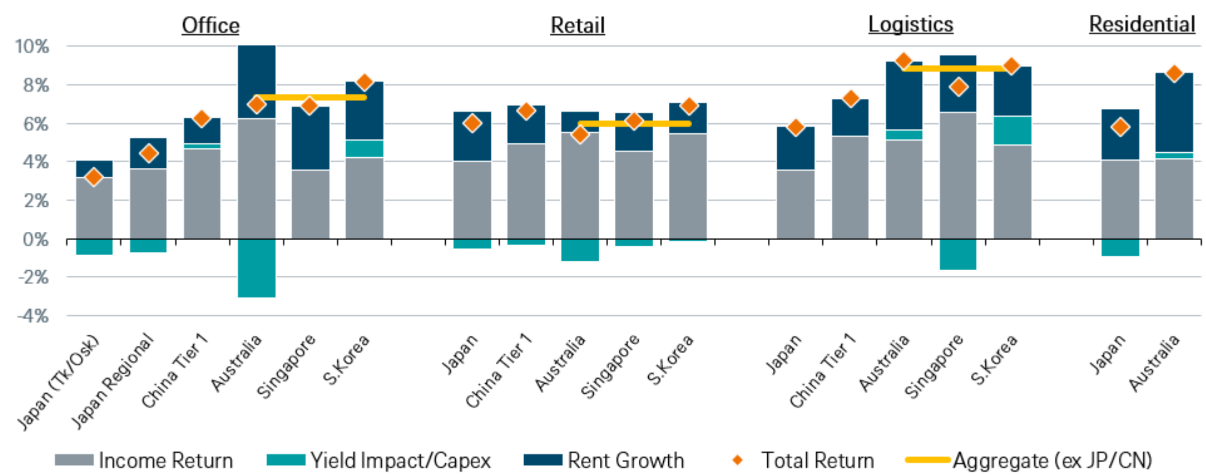
e=estimate, f=forecast. Source: DWS, Colliers, Miki Shoji, Oxford Economics. As of January 2024.

4 / Returns Outlook

Combining our house view rental growth and yield forecasts over a ten-year time horizon from 2024, we believe that the residential sector (Australia BTR) will be among the top performers, with high unlevered property-level total returns expectations over the next few years.

Prime logistics assets are also expected to outperform, delivering aggregate unlevered total returns of between 7.5% to 9% per annum. Regional cities in Japan and South Korea (not included in the forecasts below) and office assets in gateway cities outside Japan should also perform well in the long run with a recovery in asset values potentially over the next 12 months or so, though submarket differentiation and asset selection will be increasingly critical.

Exhibit 4: APAC Total Return Forecasts, (2024-2033F, p.a., Unlevered)



F = forecast. Projected returns are based on compounded basis There is no guarantee the forecasts shown will materialize.
Source: DWS. As of January 2024.

5 / Investment Strategy

Overview

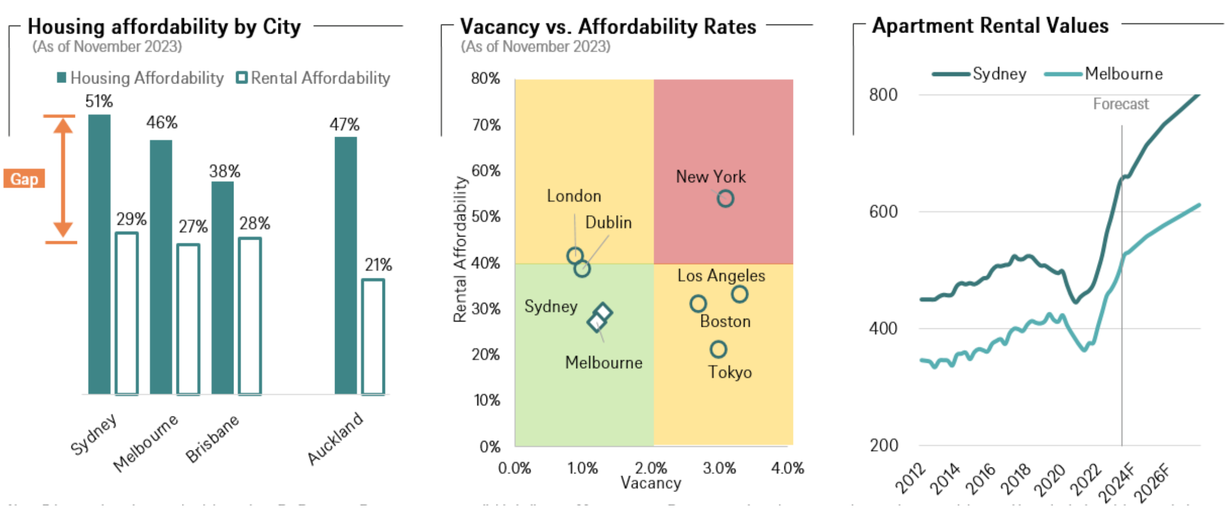
Combining our house view forecasts and strategic investment themes, we believe that investors should focus on the following key themes:

Australia: Multi-family / Built-To-Rent (BTR):

Most residential assets in Asia Pacific outside Japan are owned by individual strata-titled landlords with the level of institutionalisation still nascent. Australia is a notable exception, where the Build-to-Rent (BTR) housing model has in recent years gained traction among institutional investors looking for first-mover opportunities. The fundamental drivers for rental housing remain intact. 1) Strong population growth stemming from an influx of net overseas migration (+510k people in 2023, and additional 375k people in 2024[3]); 2) Current housing shortage with record-low new housing starts amid thousands of builder bankruptcies and elevated construction costs; and 3) Affordability calculations (Exhibit 5) showing the economics of renting being more attractive than home ownership, as mortgage affordability remains stretched by both elevated prices and high interest rates. Another tailwind for the BTR sector is the revision in legislation introducing tax concessions for new residential BTR projects from July 2024 onwards, which is expected to further open up the sector for foreign investors.

We expect city-wide apartment rents in Sydney and Melbourne to grow by around 5% per annum over the next five years and underpin investment returns. Despite the recent influx of both domestic and foreign capital into new BTR developments, the current BTR stock in Australia represents only 0.1%-0.2% of total housing stock, highlighting the development potential of the sector, similar to trends taking place in the United States, Europe and Japan. The biggest challenge for investors is gaining access to institutional quality stock, most likely involving development risk. Nonetheless, careful market selection and partnering with experienced local partners should be able to mitigate the risks.

Exhibit 5: Housing / Rental Affordability in Australia/NZ



1) Based on % of gross household income required to service an 80% LVR mortgage for a term of 30 years.
2) Rental affordability = median weekly rent / gross household income.
Source: DWS, SQM Research, Australia Bureau of Statistics, LMC, REINS. As of January 2024

South Korea: Debt Strategies

[3] ABS, CBRE, December 2023

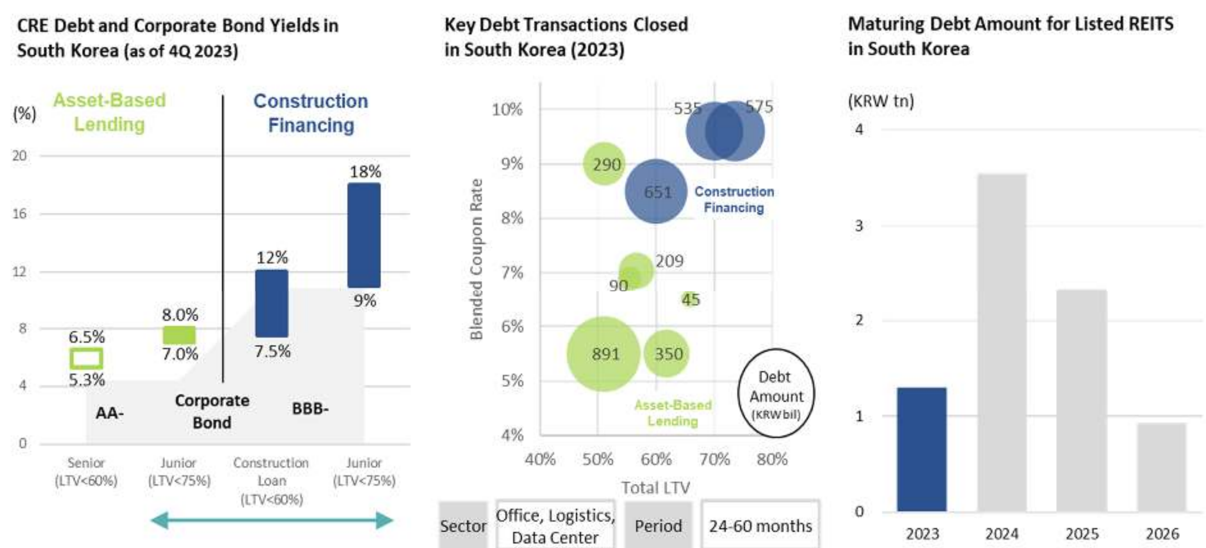
Following rapid interest rate hikes since 2022, traditional lenders in APAC real estate debt markets have been under increased pressure to tighten lending conditions and retreat from new loan approvals, opening a window of opportunity for alternative lenders to enter the debt markets and access more attractive risk-adjusted returns relative to equity in the coming years, especially in South Korea and Australia.

From the market perspective, the CRE lending circumstances in South Korea and Australia have remained almost the same at the distressed level. For example, lending yields on core stabilized assets in South Korea decreased only marginally from 5-11% to 5-8%, while yields on construction loans have reached elevated levels of around 8-18%. While equity investment activity remained weak, real estate lending comprising both asset-based and construction loans by alternative lenders have grown strongly in South Korea in 2023. The debt amounts per deal were diverse between KRW 45 billion and KRW 900 billion with blended coupon rates ranging between 5.5% and 10%, mainly from the office and logistics sectors.

We see the most compelling debt opportunities in South Korea, as maturing real estate debt is expected to peak in 2024 with an immediate need for new lenders to step in and ease constraints in the credit markets. In addition, the influx of upcoming development projects and rising investment volumes should create attractive debt investment opportunities.

The Australia debt market looks interesting as well, though new entrants need to calibrate their plans carefully given the more competitive landscape from existing alternative lenders while risks in the construction space remain high amid record bankruptcies.

Exhibit 6: Real Estate Debt and Corporate Credit in South Korea, Australia



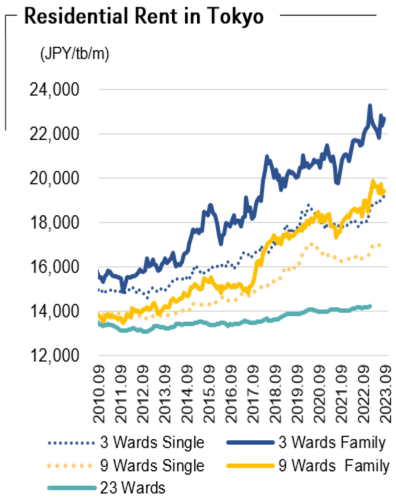
Source: DWS, Oxford Economics, Bank of Korea. As of January 2024

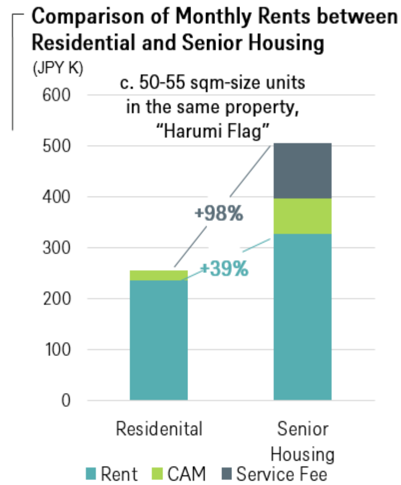
Japan: Short-Term Market Correction, Long-Term Opportunities

For Japan, a modest capital value correction is expected in 2024 driven by a potential shift in monetary policy regime by Bank of Japan, especially in the tightly priced Tokyo market. This market momentum may present a window of opportunity for investors to potentially optimize their portfolio and recycle the capital for opportunities underpinned by strong long-term growth potential, such as regional logistics or living sectors including senior housing subsector – post price adjustments which could occur beyond the next 6 to 12 months.

Especially for the living sector, along with soaring construction costs and increasing demand for higher living standards, the average selling price of newly built condominiums in Tokyo 23 wards reached a record high of JPY 131 million (per unit) in the first quarter of 2023 and remained above JPY 100 million per unit in the third quarter of 2023. Residential rents have increased rapidly, especially family-type units with multiple bedrooms which cater to high-income working professional couples on work-from-home arrangements living in inner city areas. The market momentum for condo price growth could weaken depending on the potential shift of monetary policy by the Bank of Japan in 2024, while the leasing demand for good quality rental houses should remain resilient in the coming years.

Exhibit 7: Japan Residential / Senior Housing Trends





Recent Developments of High-End Senior Housing by Developers

Developer	Total Properties completed since 2020)	Area
Tokyu RE	26 (7)	Greater Tokyo
Nomura RE	7 (6)	Greater Tokyo
Mitsui Fudosan	6 (5)	Greater Tokyo Greater Osaka
Mitsubishi Estate	1 (1)	Tokyo

Source: DWS, CBRE, JLL, METI, LMC, REINS. As of January 2024.

Regional: Value-Add Strategies:

The key challenge in the current investment environment is that straight forward buy-and-hold core strategies may not meet the steeper returns hurdle institutional investors are increasingly seeking, even among core-focused investors. Faced with higher financing costs and risk-free rates, we have seen investors turn towards value-added deals offering at least double-digit returns. One example is the Australia BTR strategy as identified above, while we also outline a few other investment strategies below which investors seeking higher risk-adjusted returns may consider:

Tactical Investments

Compared to a year ago, we have seen more advanced repricing occurring, with some real estate owners either facing loan refinancing challenges or collateral calls due to significant appraisal devaluations (particularly on secondary assets) leading to a breach of LTV or interest coverage covenants. This would require recapitalization or loan refinancing at a time when bank lending availability is limited. CBRE had estimated a debt funding gap of US$5.1 billion by 2025 across Asia Pacific, led by Australia, Japan and South Korea, particularly in the office space.

As such, investors could seek out structured deal opportunities in bridging the funding gap, which could involve additional capital injection through preferred equity, mezzanine lending or a combination of both. The investment quantum for these types of structured deals would be relatively small, with a short investment period. However, with the opportunity to achieve repricing discounts from weak sellers facing liquidity issues, investors could achieve higher risk-adjusted returns compared to common equity or senior lending. We view the logistics sector, and selective office segments underpinned by strong demand-supply fundamentals in core locations as favourable targets, through development funding, forward purchases or completed sale opportunities.

Asset Repositioning

The evolving real estate landscape has witnessed structural shifts in stakeholders' requirements – tenants, landlords, financiers, particularly in a post-COVID environment where a multitude of factors such as flexible working arrangements, ESG features, and portfolio de-risking takes centre stage.

Investors could seek older but well-located office buildings with upgrading potential to bring the development up-to-date though asset enhancement initiatives. Having next-generation office features such technological features, biophilic design and collaborative spaces appeal strongly to the millennial worker while re-leasing with the accompanying rental uplift typically provides double digit returns on the capital outlay if executed well, outperforming a buy-and-hold core strategy. For example, in Australia, spec fit-outs and leasing up of furnished spaces increases the prospects for landlords to attract tenants and advance leasing progress when market vacancies remain elevated.

Operational Real Estate

As investors look to focus away from traditional asset classes such as retail and office, interest has grown in alternative real estate such as data centres, purpose-built student accommodation (PBSA), senior housing and co-living among others. These segments are often driven by long-term technology or demographic trends from specific demand segments while their nascent market maturity indicates that investors could seek higher returns from a combination of higher yields or additional operating margins through active management. For example, PBSA assets can command a yield premium of 50-75 bps over comparable residential build-to-rent developments in Australia.

While investments in these niche segments may appear more appealing than traditional asset, investors would need to conduct further industry due diligence and consider some factors including operational risks, in-house management capabilities and achieving product scalability at the platform level.

New Markets

Beyond the developed countries in Asia Pacific, the emerging economies of China, India and ASEAN serve large population bases offering operational scalability and growth potential for new investment frontiers including real estate. Ongoing geopolitical tensions have accelerated the 'China Plus One' strategy which should speed up supply chain diversification and increase manufacturing activities in the region.

India's rapidly growing economy and rising market institutionalization have put it on the radar of foreign investors. No doubt, major challenges such as regulatory red-tape, transparency and liquidity issues remain a hurdle for most core investors, with India contributing only about 2%-3% of investment volumes in Asia Pacific. Yet, as the country's real estate develops in maturity, it may be worthwhile for investors to start considering portfolio allocations in the medium term.

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