Asia-Pacific

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The economic climate in Asia shares similar characteristics to the other major regions, but with less turmoil and relatively tame inflation, thus far. Climate change still poses a major threat in the region, and at the time of writing this note, China's COVID-19 lockdowns are taking a toll on its economy. China is such a meaningful contributor to the region's (and world's) output that a slowdown there has real consequences for the overall Asian economy. Exports have continued to do well over the last year – a critical support for many of the region's major economies – but that contributor to economic output could begin to suffer as external demand weakens with potential recessions in Europe and the United States. Despite these challenges, Asia has been faring notably better with fewer challenges than some of the world's other major economies.

As inflation makes its presence felt in all regions of the world, concerns about a global recession have been looming. Most of Asia's sub-regions are already in the mid-cycle phase of recovery. Asian central banks have taken some steps to tame inflation—but have not felt the pressure to raise rates or enact stimulus packages. Average inflation peaked at 5.5% and by August 2022 was already down by about 0.50% from peak levels.[1] China and Japan, which accounted for 60 percent of the region's real GDP in 2022,[2] have seen relatively moderate inflation. Energy costs in Asia constitute a smaller share of consumer inflation indices, as they have not risen at the same rates seen in the United States and Europe.

Cost pressures for materials, commodities, and labor have been felt globally. New construction projects require built-in cost contingencies to attempt to safeguard financial success. Supply chain disruptions have begun to show pockets of improvement but have continued to significantly impact construction timelines.

"Optimistic uncertainty" sets the tone as we move into 2023. Asia could potentially be pushed into a moderate recession by continued weakness in China and a loss of demand from its overseas export markets, but we believe inflation has a better chance of moderating here.

INVESTMENT OUTLOOK

In Asia, the regional price-discovery process appears to lag the United States and Europe. Apart from Japan, where Tokyo office cap rates fell in the second quarter 2022, initial signs indicate that cap rates are rising in response to higher debt costs in Korea and select markets in Australia and Singapore. Our deal teams have been seeing real-time evidence of meaningful cap rate increases, even in logistics. With higher debt costs, the opportunity for leveraged yield in Asia has largely evaporated.

[1] *https://www.cnbc.com/2022/08/16/inflation-in-asia-has-peaked-morgan-stanley-says-.html*
[2] *According to the International Monetary Fund: https://countrycassette.com/list-of-asian-countries-by-gdp-2022/*

We believe pricing is the key determinant in the scale and duration of any downturn in property values during a crisis or recession. As 10-year sovereign bond yields continue to increase, current yields can be used to calculate cap rate spreads across regions and, in turn, re-estimate pricing for markets. By this methodology, only about half of Asian markets are expensive, in contrast to 70 percent of U.S. markets—suggesting a less severe property downturn in Asia (as of 2022Q3).[3]

Asia's property market is expected to outgrow the United States and European markets, driven by a combination of value gain for existing property but also newly developed stock. Hines Research estimates that the total value of investment property in Asia across the four major property types should outgrow U.S. and European investment property market value over the coming decade. The pace of that growth should be such that Asia will grow from holding its smallest share of investment property at 30 percent in 2022 to the highest share of 36% by 2032.[3]

Our response is to be patient through pricing fluctuations and focus on strategies that lean into non-discretionary demand and sectors/markets where rents should ultimately benefit from inflation. Amongst continuing opportunities across all the region's major economies, we have found very compelling opportunities in for-rent residential in Japan, build-to-rent in Australia and office in India. With values for secondary-quality assets likely under pressure, we could purchase select assets in attractive locations at discounted prices for our Core Plus Fund, Hines Asia Property Partners, with an eye to "fixing" to proper Core for the long-term; or take on assets with a traditional value-add approach. In addition to the opportunity proffered by an expected repricing, the growth in Asian property markets noted above will lead, we believe, to significant, measurable opportunities for development in both Asia's developed and developing economies. To capitalize on this outlook most effectively for both our business and our investors, we are exploring options for a new Asia Pacific Fund designed for just that purpose.

SECTORS IN OUR SIGHTS

In addition to some of the current opportunities discussed already, over the long term, we are optimistic about the office, life sciences and mixed-use / retail sectors in the Asia Pacific region. We are also focused on sustainability as companies aim to attract an eco-conscious workforce and meet corporate goals for carbon emissions reductions.

Against the backdrop of this year's macroeconomic and political headlines, the rebalancing of real estate product types has largely played out. While trends have indicated that the real estate industry's main sectors may converge further, the current picture drawn from Hines research and local teams' intelligence shows that sectors remain quite differentiated.

INDUSTRIAL

Tailwinds continued, but market has gotten tighter

- Investors and developers have been looking to avoid obsolescence in their properties and demand for higher clear heights and more efficient locations and configurations
- The Asia Pacific region has continued to see a relative shortage of logistics space for products addressing e-commerce demand; and as Asia's economies become wealthier, there is a scope for more cold-storage demand
- Micro-location analysis, asset selection and design prowess have become critical in this crowded market for investors

LIVING

Addressing affordability and upgrading aspirations

- Rental demand has been supported in markets where homes have become increasingly unaffordable; this includes developed markets like Australia, Korea and Japan.
- In developing markets, consumers have ownership aspirations and have sought affordable or next-level up housing

[3]*Per Hines Proprietary Research as of 3Q22*

OFFICE

Evolution, not revolution

- We have seen strong growth in high-value locations
- With a lower susceptibility to "Work from Home," as well as relatively healthy office-using employment growth, there are indications that office demand may likely seep into lower quality segments in Asian markets; the implication is that the office investment opportunity would be more broad-based in Asia relative to expectations in Western markets. Return-to-office requires a new dimension of user experience to attract tenants.
- We have found a noteworthy correlation between funding and space demand for Life science facilities. The levels of life sciences venture funding targeting the region, if it continues, will lead, we believe, to demand growth for the region in aggregate that trails only the major life science clusters of the US.
- Investors have been pursuing ESG initiatives that enhance returns and bring operational efficiency

RETAIL

The Yield Play

- Yields for retail assets – while varying by sub-type – have been attractive relative to other property sectors. We see increased stability in retail fundamentals as vacancies and rents have been stable or moving in the right direction.
- Investor sentiment has reached a point at which we may see more upside than downside in pricing of some products; investors have become increasingly confident that we have seen a shake-out of poorly performing assets, but more importantly, the market now understands what types of retail and which locations can thrive moving forward
- Even well-located prime retail has been being priced at levels significantly lower than pre-COVID levels

EMERGING SECTORS

Offering higher yields and room for upside

- Sectors are institutionalizing, suggesting higher income yields and growth prospects

RESPONSIBLE INVESTMENT

Asia Pacific countries with supportive government policies that require energy-efficient buildings are leading the region's race to net zero. All countries in the region have made pledges as part of the Paris Climate Accords - an international treaty on climate change. Many of the largest economies have recently made ambitious commitments to reduce emissions and achieve carbon neutrality. In Singapore, 95% of Class A office stock is rated under the Building and Construction Authority's (BCA) green building rating system,[4] and all new buildings are subject to the green rating requirement. In Australia, a newly passed climate change bill[5] is also expected to accelerate the adoption of green leases as part of carbon-reduction efforts.

Beyond regulatory pressure, some corporate occupiers have pushed for green leases. Across the Asia Pacific region, 42% of occupiers have already signed a green lease and another 43% plan to do so by 2025. Green leases have traditionally been focused on environmental clauses, but more companies in Asia Pacific are planning to include environmental, social and governance (ESG) clauses when they renew their leases.[6]

Consistent and well-proportioned investments in ESG upgrades aim to produce higher occupancy rates, as occupiers often appear to prefer more sustainable properties. For investors, ESG investment may add liquidity and better pricing at exit with protection from "brown discounting." The present moment is a good window in which to consider advancing ESG investments.

CONCLUSION

In the long term, we remain optimistic about investment in Asia. The region is buoyed by a unique growth profile, relative to the US and Eurozone, for both Asia's economy and the underlying property markets, a key pillar for economic output. We are focused on sustainable properties in the region as governments continue to create new regulations related to decarbonization in the built environment.

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