

2024

Asia Pacific

# EMERGING TRENDS IN REAL ESTATE®



# Emerging Trends in Real Estate® Asia Pacific 2024

A publication from:



# Emerging Trends in Real Estate®

Asia Pacific 2024

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Recommended bibliographic listing:

PwC and the Urban Land Institute: *Emerging Trends in Real Estate*<sup>®</sup> Asia Pacific 2024. Washington, D.C.: PwC and the Urban Land Institute, 2023.

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# Executive Summary

The series of quick-fire rate hikes initiated by the US Federal Reserve in mid-2022 has marked an end to the era of low-interest-rate investing in place since the global financial crisis in 2008. In a sense, higher interest rates are simply a reversion to the mean, returning cost of capital to historical norms. At the same time, however, in the context of a market habituated to abundant supplies of cheap debt, rising rates represent a sea change in the way investors underwrite deals. The impact on real estate markets has been felt in a number of ways:

**Higher interest rates lead to asset revaluations.** As financing costs increase, the yield required by investors ought logically to increase to allow income generated from assets to rise above the cost of investing. This means that the ultra-compressed cap rates that have become the norm across Asia Pacific markets should in turn move out, with corresponding downward revisions in asset values. So far, however, asset owners have been slow to embrace this new normal, mainly because they have felt little pressure from regional banks to enforce loan covenants or otherwise reprice.

**Many investors have moved to the sidelines.** In the absence of asset revaluations, far fewer deals are now able to deliver accretive returns, prompting investors to retreat to the sidelines as they wait for markets to reset. This retrenchment has been led by large global investors, who have to a great extent disappeared from the market. The major exception to this trend is Japan, where interest rates remain at rock-bottom rates of around 80 basis points, allowing the required spread over the cost of debt to remain in place. For many foreign fund managers, Japan is currently the only destination in the Asia Pacific where they are willing to deploy capital at all.

**Traditional asset classes lose their shine.** One reason global investors have withdrawn from regional markets is that the types of deals they have traditionally pursued – large, core, office and retail assets – have fallen from favour. Office investments, in particular, have been affected by the reluctance of owners to allow cap rates to expand to match values underwritten by potential buyers, resulting in a bid-ask standoff. Otherwise, values have been tainted by association with collapsing values in some office sectors

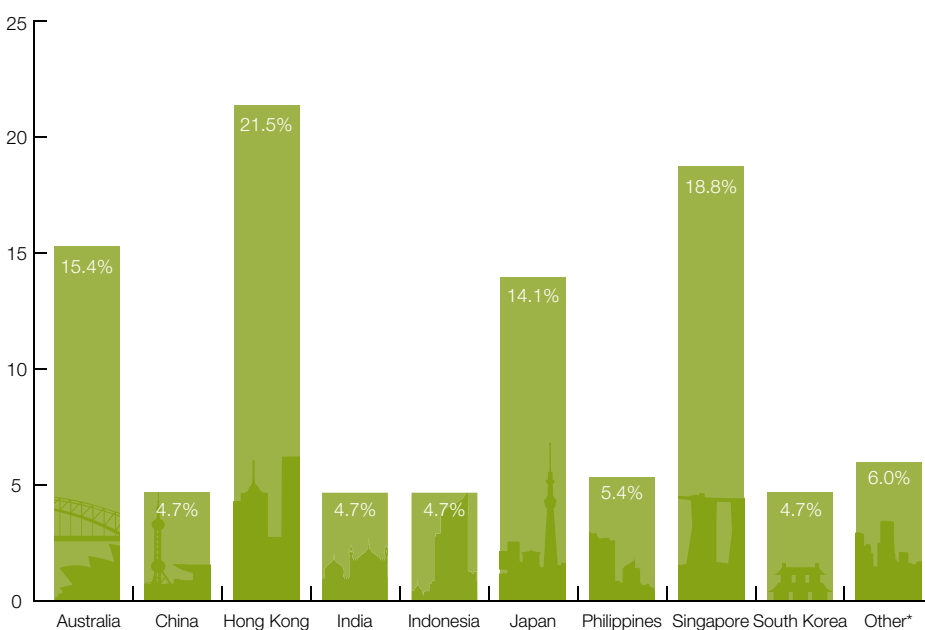
in the West, where utilisation rates stuck at around 50 percent of pre-pandemic levels have raised fears of a potential decline in secular demand.

**Investors are pivoting to alternative assets.** As funds seek out assets that offer yields that can match their revised underwriting thresholds, alternative asset classes have become a focus. Alternatives offer a number of features traditional asset classes do not: better long-term growth potential; possibilities to tap tailwinds of demand generated by technological, demographic, or social trends that are uncorrelated with macro-economic fluctuations; structures – such as short weighted average lease expiries (WALEs) – that protect against inflation; and, finally, a tendency to incorporate operational components that generate profit beyond returns from pure real estate. The most popular alternatives include those in the “beds” category (including multifamily, student housing, senior living, and hotels). In addition, investors are migrating towards logistics, data centres, and life science assets.

**Transition risk comes to the fore.** Energy intensity issues are rapidly gaining momentum as market forces drive home the reality that valuations of buildings that fail to comply with baseline environmental standards may be discounted by the market, as investors, tenants, and regulators increasingly discriminate against them. That said, awareness of transition risk varies widely by market (with Australia, Singapore, and Japan currently leading the way) and by type of asset owner. Unsurprisingly, while sophisticated international players have a more informed perspective, many asset managers throughout the region, especially in non-gateway cities, remain relatively uninformed about energy intensity and other environment-related issues.

**Refinancing issues are looming.** The impact of today's higher-interest-rate environment is not limited to investors looking to finance new deals, but applies equally to owners who purchased assets in recent years when debt was cheaper

## Survey Responses by Country/Territory



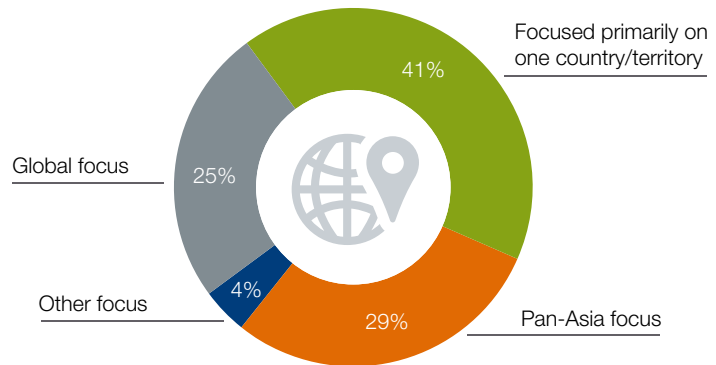
Source: *Emerging Trends in Real Estate Asia Pacific 2024* survey.  
\*Includes Cambodia, Malaysia, Taiwan, Thailand, USA, Vietnam.

who must now justify their underwritten values to lenders as their loans come up for refinancing. In the West, banks have been reluctant to accept the ongoing validity of such underwriting assumptions and are therefore offering to refinance – if at all – only on the basis of values that are significantly lower, thereby forcing owners either to recapitalise assets to match new loan-to-value ratios, or else sell their properties. This is one reason values in Western markets have declined so fast and so steeply. In the Asia Pacific, banks steeped in a more relationship-driven approach to deal financing have historically been more accommodating on valuation issues. In the current environment, however, there is no guarantee that traditional practices will persist, creating the prospect of a “refinancing wall” that may drive a wave of selling by owners unable or unwilling to recapitalise.

**Private credit is stepping in to fill the financing gap.** One consequence of newly tightened bank lending regimes is that real estate debt is now being offered by significant numbers of non-bank players, including cash-rich institutions and, increasingly, pure-play private equity funds. This marks the start of what may be a fundamental shift away from traditional bank-dominated real estate lending towards non-bank debt structures along the lines of the more mature private credit markets in the United States and Europe. For now, demand for non-bank debt tends to be clustered in specific geographies, asset classes, or situations. Although development finance is one area of interest, the spotlight has fallen in particular on filling a “funding gap” that has emerged as banks decline to refinance existing loans, forcing owners either to sell or to find more expensive capital from private credit lenders. As much as US\$5.8 billion in refinancing capital is expected to be needed for these purposes in the near term, according to CBRE estimates.

**Intra-Asian buying continues, but global flows are shrinking.** Against a backdrop of sharply reduced overall investment, the share referable to regional

## What is the geographic focus of your business's activities?



Source: *Emerging Trends in Real Estate Asia Pacific 2024* survey.

cross-border flows has held up well (i.e., flat, year-on-year in the third quarter of 2023) compared to plunging transactions from global funds (down 64 percent for the same period). One reason for the relative strength of intra-Asian flows – in particular those from Singapore – has been the resilience of regional economies, while another has been an upswing in outgoing capital from Japan in search of higher returns. Meanwhile, global funds have been handicapped by a combination of factors – higher return thresholds, lack of appetite for traditional office and retail assets, and the “denominator effect”, which requires them to rebalance portfolios to account for sinking values of their fixed-income holdings.

Turning to this year’s *Emerging Trends* investment prospect rankings, Japan’s persistently low cost of capital has made it the overwhelming favourite among cross-border investors, with Tokyo and Osaka taking first and third places, respectively. Multifamily projects have been especially sought after. Sydney and Melbourne also feature strongly, reflecting an historical preference among global investors for Australian core assets, despite a lack of recent deals caused by a stubbornly wide bid-ask gap. At the other end of the table, Chinese properties are currently off the table for the majority of foreign funds. Despite a target-rich environment of potential deals, investors

remain wary of both ongoing geopolitical tensions and structural issues in the domestic economy.

Individual asset classes, meanwhile, are still in the throes of often-profound change:

**Office:** As noted above, the office sector’s star has fallen as a result of potential structural declines in tenant demand. While office utilisation in the Asia Pacific has not (with the exception of Australia) fallen to anything approaching levels seen in Western cities, fund managers are opting to sit out the storm rather than buy assets at what anyway seem to be inflated valuations.

**Logistics:** On paper, structural undersupply of modern logistics infrastructure appears to make the investment thesis as bullish as ever, with rental growth in most locations (especially Australia) confirming ongoing demand. At the same time, some investors see a cyclical peak approaching, with cap rates remaining tightly (and perhaps overly) compressed, effective rents that often significantly lag face rents, and the rent-growth story perhaps not as plausible as vacancy levels suggest. Data centres, meanwhile, are enjoying spectacular growth on the back of a wave of new AI apps that are generating huge demand for new data capacity.

**Retail:** The long-suffering retail sector appears to be on the mend, with significant numbers of investors indicating willingness to buy retail assets in principle, even if very few of them are yet doing so in practice. Cap rates remain too compressed for now, although investment volumes could quickly rebound if anticipated rental growth arrives.

**Residential:** Multifamily is probably the single most preferred asset class in the Asia Pacific. This is due to a combination of factors: on the one hand, high property prices and potentially recessionary economic conditions are persuading consumers to rent rather than buy, while on the other, the sector offers the benefit of reliable income streams in combination with short-term lease structures that reset easily to counter inflationary

pressures. Doubts persist as to whether low returns on multifamily assets will prove sustainable over the long-term, however. In addition, and for the same reasons, investors have been drawn to other asset types within the overarching “beds” sector – interest in student accommodation and senior-housing assets has proved especially strong.

**Hotels:** As regional travel and tourism markets rebound after years in the COVID doldrums, investors are today actively pursuing hotel deals, especially for properties in Japan, where almost half of all third-quarter 2023 transactions took place. That said, the wide gap between buyer/seller pricing expectations has depressed buying activity and left private investors, family offices, and high-net-worth buyers as the main players.

Strong demand for rooms is expected to continue as a result of both capacity shortages and the gradual return of more Mainland tourists to regional markets in 2024 and beyond, in particular to previously popular destinations such as Japan and South Korea.

## Notice to Readers

*Emerging Trends in Real Estate® Asia Pacific* is a trends and forecast publication now in its 18th edition, and is one of the most highly regarded and widely read forecast reports in the real estate industry. *Emerging Trends in Real Estate® Asia Pacific 2024*, undertaken jointly by PwC and the Urban Land Institute, provides an outlook on real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues throughout the Asia Pacific region.

*Emerging Trends in Real Estate® Asia Pacific 2024* reflects the views of individuals who completed surveys or were interviewed as a part of the research process for this report. The views expressed herein, including all comments appearing in quotes, are obtained exclusively from these surveys and interviews and do not express the opinions of either PwC or ULI. Interviewees and survey participants represent a wide range of industry experts, including investors, fund managers, developers, property companies, lenders, brokers, advisers, and consultants. ULI and PwC researchers personally interviewed 54 individuals and survey responses were received from 149 individuals, whose company affiliations are broken down below.

Private property owner or developer	22%
Real estate service firm (e.g., consulting, financial, legal, or property advisory)	25%
Fund/investment manager	31%
Homebuilder or residential developer	2%
Institutional equity investor	2%
Bank lender or securitised lender	2%
Other entities	15%

Throughout the publication, the views of interviewees and/or survey respondents have been presented as direct quotations from the participant without attribution to any particular participant. A list of the interview participants in this year’s study who chose to be identified appears at the end of this report, but it should be noted that all interviewees are given the option to remain anonymous regarding their participation. In several cases, quotes contained herein were obtained from interviewees who are not listed. Readers are cautioned not to attempt to attribute any quote to a specific individual or company.

Please note that in the text “China” refers to “Chinese mainland”, and “Hong Kong” refers to “Hong Kong SAR”.

To all who helped, the Urban Land Institute and PwC extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.



# Chapter 1: Reinventing the Mousetrap

“The stagnant trend we’re seeing is about price discovery playing out, and that’s a result of cost of debt – in no market in Asia except Japan is it now accretive to invest.”

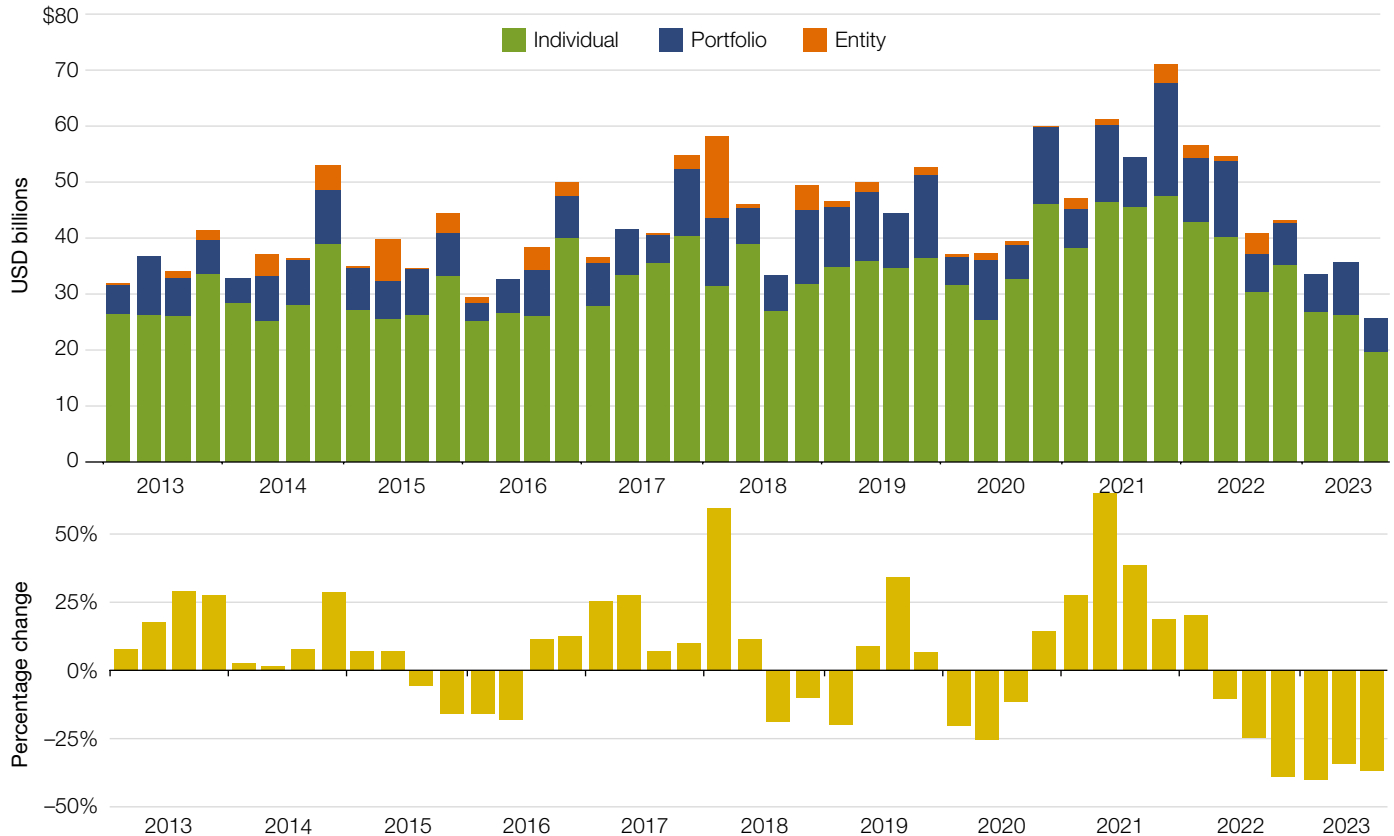
In the 13 years since the global financial crisis ushered in a long era of ultra-low interest rates, real estate markets across the Asia Pacific had been pushed in the direction of a single mainstay strategy: use cheap leverage to buy core assets, ride the tailwinds of cap rate compression, then exit with generally handsome returns to one of many institutional buyers armed with a share of the region’s growing surplus of investment capital. For years, this rather straightforward trade generated good returns. However, once the easy money had been made, markets

continued to coast along on a wave of rising prices, with investors trapped in an endless “quest for yield” until the constraints of affordability dictated that values and rents could rise no further.

Today, that cycle has been broken. With interest rates in the West rising at the fastest pace ever, the old formula of leverage and cap rate compression no longer computes, forcing investors to find other ways to drive profit as markets anticipate a reset around new measures of value.

This change brings with it several consequences. First, buyers throughout the region have gathered on the sidelines as they await an event to trigger that reset, with systemic stress caused by a ‘higher for longer’ rate regime a likely cause. Second, the entrenched nature of relationship-based banking in the region means that sellers are still under little pressure from lenders to lower asking prices. A bid-ask spread has therefore emerged in most markets, with the widest in Australia and Hong Kong and the narrowest in Singapore and South Korea.

Exhibit 1-1 Asia Real Estate Transaction Volumes by Source of Capital, and Year-on-Year Percentage Change, 3Q 2023



Source: MSCI Real Capital Analytics.

Note: Apartment, hotel, industrial, office, retail, and senior housing transactions included. Entity-level deals included. Development sites excluded.

Finally, the freeze in transactions applies in particular to the realm of big-ticket purchases where global buyers have traditionally congregated. As one investor put it: “Outside of Japan, markets in northeast Asia and even Australia are withering away in terms of transactions because it’s only domestic capital that’s throwing it in, not big external capital.”

Nor, as of writing, is a resolution in sight – regional markets remain hostage to elevated US equity prices, stubbornly high inflation, and headline economic numbers that suggest ongoing strength, even as other indicators imply fundamentals are deteriorating.

As a result, markets are in limbo. As one fund manager said: “I feel we’re going to be stuck in the mud for another year because I don’t see a catalyst for change. People are going to be head down, focused on managing their assets to the best of their abilities. But what will happen at some point is that there’s going to be stress/distress, where lenders start to take control and people start defaulting on covenants. It’s going to require a shock to particular positions for them to be unlocked.”

### Office Deals Plummet

While transactions across all asset classes began falling in the second half of 2022, downward momentum has been unrelenting, with deals across the region dropping 37 percent year-on-year to US\$25.7 billion in the third quarter of 2023, according to analysts MSCI (see exhibit 1-1). Although steep declines were seen in all major markets, in percentage terms the biggest drop was in Australia (down 65 percent year-on-year), as high asking prices led to a widening gap in buyer and seller expectations.

Surprisingly, however, wilting regional transactions seem to have had little impact on profit projections in our survey (see exhibit 1-2), which remain well above levels in both 2021 and the global financial crisis in 2009. This perhaps reflects the fact that both industry and economic fundamentals are not as weak

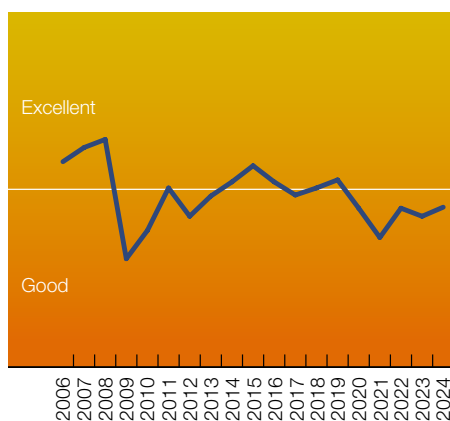
as they might be. Vacancies and rents may be soft, but investor leverage is generally lower, gross domestic product (GDP) growth remains acceptable, banks appear to be still onside, and there are tantalising prospects of a new horizon of profitable investing once valuations eventually find their level. “We’ve been waiting for this moment since the global financial crisis,” as one investor commented, hinting at the underlying reality that current events are as much a reversion to the mean as they are a shift in industry paradigm.

The most interesting aspect of regional transaction trends relates to the diverging performance of individual asset classes. Multifamily and industrial properties have held up relatively well, therefore, whereas retail, and particularly offices – previously core investors’ go-to purchase options – have fallen sharply (see exhibit 1-3). In the words of a fund manager in Singapore: “It’s shocking to me how interest has moved away from office, which used to be institutional-grade covenant, long leasehold, the core, easy, big-ticket size. But now, that thesis, from an investment manager’s point of view has changed – office just doesn’t offer that quality of secured income that it used to.”

This means, as one Australian-based fund manager commented, that “people are avoiding well-trodden paths such as office. Selectively, we will look at it from the bottom up, but as a sector, the structural headwinds it faces with hybrid working and supply-demand dynamics makes it a challenging leasing market in most places across the region outside of Korea.”

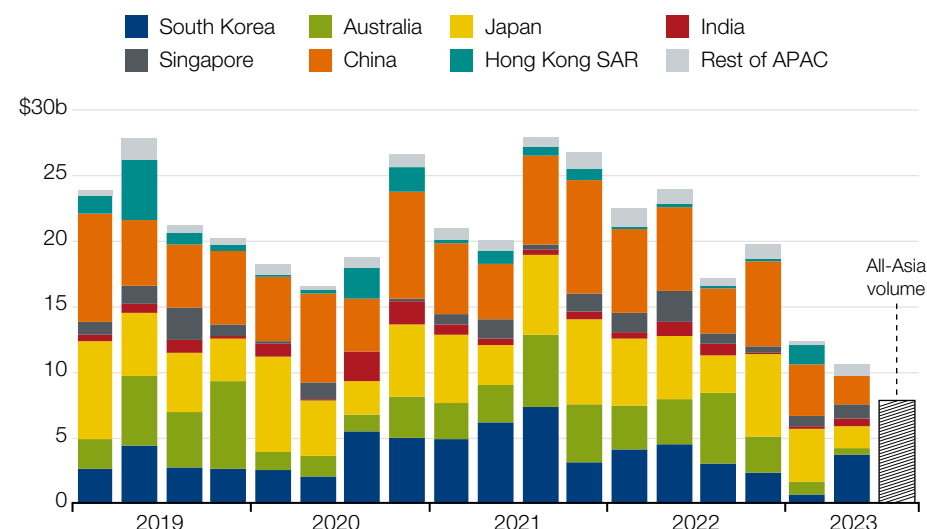
Compared with pre-COVID transactions from 2019, when first-half Asia Pacific office transactions amounted to some US\$40.6 billion (representing 56 percent of commercial real estate deals), sales shrank to US\$23 billion by the first half of 2023 (i.e., 37 percent of the total).

Exhibit 1-2 Real Estate Firm Profitability Trends



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

Exhibit 1-3 Quarterly Office Deal Volume across Markets, 3Q 2023



Source: MSCI Real Capital Analytics.

The falloff has been much steeper among cross-border investors, where activity in many cases has ground to a halt.

In part, the plunge in transaction volume is caused by anxiety about how rising interest rates will affect yields. But given that significant declines were seen also in Japan, where low interest rates have remained flat, and that other asset classes have suffered correspondingly less-severe downturns, there is little question that office-sector weakness is also a function of structural concerns surrounding long-term demand. As one fund manager put it: “This is not just a financial crisis for office; it is an existential crisis in terms of what is the use case for office.”

Nor is this surprising. By voting with their feet in this way, investors have in mind recent office-sector outcomes in the West, where work-from-home practices have proved hard to dislodge despite increasingly vocal employer directives, leaving workplace occupancies in many cities at levels that have become economically unsustainable for owners.

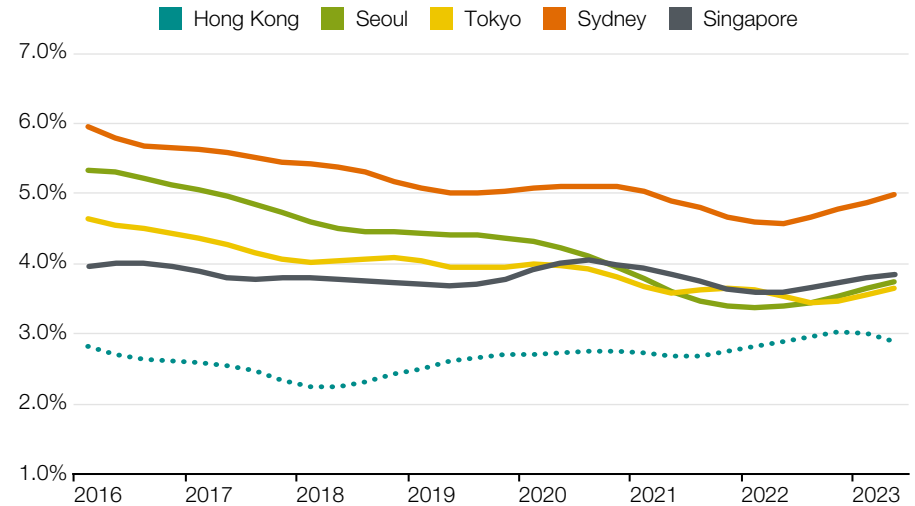
A report in August 2023 by Australian workplace sensor provider XY Sense found that global rates of office utilisation remained stuck at about 50 percent of pre-pandemic levels, while a July 2023 analysis from management consultants McKinsey predicted demand for office space in nine “superstar” cities – including New York, San Francisco, London, Paris, and Tokyo – would be 20 percent lower by 2030 compared with 2019 levels (and as much as 38 percent lower in a worst-case scenario).

That said, the good news in an Asia Pacific context is that work-from-home mandates have generally had a far shorter half-life than in the West. The impact on vacancies and utilisation has therefore been more muted, with a mid-2023 estimate by CBRE showing Asia Pacific occupancy at just 10 to 15 percent below pre-pandemic levels.

### Assets Slow to Reprice

Nonetheless, steep year-on-year declines in commercial real estate values in Europe

Exhibit 1-4 Asia Pacific CBD Office Yields, Q3 2023



Source: MSCI Real Capital Analytics.

and the United States (i.e., 21 percent and 19 percent, respectively, in the second quarter of 2023, according to California-based analysts Green Street Advisors Investors) are hard to ignore, especially with office sectors once again in the firing line, with declines of 29 percent and 31 percent, respectively. In major markets such as London, New York, and San Francisco, office values dropped even further.

So far, however, Asia Pacific real estate has proved stubbornly resistant to change, with only marginal cap rate expansion as of writing, and prices weakening 10 to 15 percent across most regional markets (and 20 percent in Sydney), according to a brokerage source. This provides more incentive for investors to lie low as they wait to see how the repricing exercise, which higher interest rates make inevitable, will eventually roll out.

In part, asset revaluations forced by rising interest rates reflect the financial reality that investments usually make no sense if they yield less than the cost of debt used to buy them. Logically, therefore, cap rates should move out to re-establish a spread over today’s higher cost of capital. However, while interviewees agreed that regional assets will reprice, they also suggested that

write-downs in the Asia Pacific will be less convulsive than they have been in the West, where the revaluation process is by now well advanced.

There are various reasons for this. First, deals for commercial real estate in the Asia Pacific are structured differently than they are elsewhere. In the United States, for example, bank lending represents about 40 percent of total commercial real estate debt, according to Moody’s, with the rest held by a combination of government agencies, insurance companies, non-bank lenders, and within securitised instruments such as commercial mortgage-backed securities (CMBS). Beyond that, the debt is distributed among the different parties in ways that make them interdependent. Banks, for example, will typically originate loans with an expectation they will be spun off as securitised debt, such as CMBS. At the same time, banks and insurers are some of the biggest buyers of senior CMBS, so bank balance sheet liquidity also affects CMBS market liquidity.

These interconnected relationships provide lenders less discretion as to whether defaults should be enforced, leading to distressed properties being flushed quickly onto the market, in the process creating new pricing benchmarks on which upcoming transactions can be based.

In the Asia Pacific, however, at least 80 percent of commercial real estate lending is arranged through relationship-based regional banking, which has historically been less inclined to enforce default events. In addition, real estate investments in general are more conservatively leveraged than in the West, giving banks more comfort that collateral is sufficient, and removing what one investor called a “natural structural trigger” for chain-reaction defaults.

Another reason for the slower pace of repricing is that asset values in the Asia Pacific are set by appraisers on the basis of other recently transacted deals, as opposed to metrics such as market sentiment or long-term mortgage thresholds used in other parts of the world. In fast-moving markets, however, this approach creates a catch-22 situation where benchmarks cannot be set because there are no trades due to the lack of other recent benchmarks. In the words of a Singapore-based debt specialist: “The reality is that valuations should be down already, but that’s not how the system works. The system works where the value is influenced by the borrower and they [together] sustain super-low cap rates that make no sense at all. This is why there is still a 3.5 cap [rate] on assets in Hong Kong when you’re borrowing at 6.5 percent.”

Revaluations must happen at some point, though, for markets to function, and signs began to emerge in the second half of 2023 that banks are becoming more willing to drive this process as they address the deteriorating quality of loan collateral.

According to one interviewee: “What’s going to happen is that as you get more deals where lenders say, ‘I’m out, and you have to do something,’ some of those [assets] will end up being distress sales.”

The super-compressed cap rates common in many markets in the region may accelerate this process because a move of, for example, 100 basis points from a cap rate of 3 percent has a much larger impact on net operating income than the same move from a cap rate of, say, 5 percent.

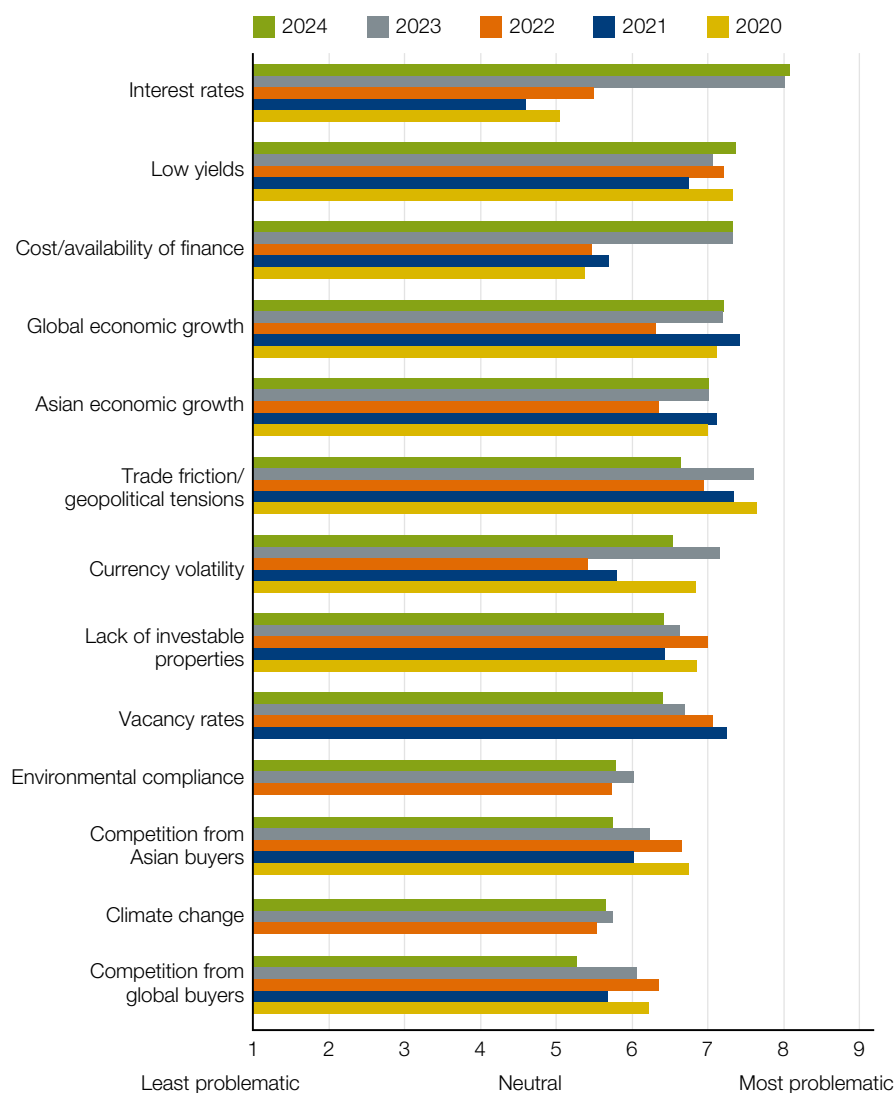
Two main default scenarios are likely:

1. Banks in some cases decline to refinance loans as they mature, or if they do so, only on terms requiring lower loan-to-value (LTV) ratios that require buyers to inject more equity. “We’re at the early stages of that happening, so assets will either be refinanced at more expensive private-capital rates, or they’ll be sold,” said the debt specialist.
2. If asset values fall to a point where they breach leverage covenants, borrowers must either provide more

equity or sell the asset. With some notable exceptions, this is less likely to happen in Asia Pacific markets because LTV ratios are generally low. The highest are in Japan, but because Japanese interest rates remain flat, there seems little prospect of LTV problems. Alternately, if borrowers are unable to meet interest coverage ratios (ICRs), sales may again be forced.

Bank scrutiny of LTV ratios and ICRs will probably differ significantly according to asset class, with multifamily and industrial properties, for example, unlikely to be considered overleveraged given how

Exhibit 1-5 Most Problematic Issues for Real Estate Investors



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

far capital values have risen in recent years. Retail properties, meanwhile, have largely already repriced, while hotels are also seen as relatively safe because they trade at higher yields and currently enjoy strong cash flows. Central business district (CBD) offices, in contrast, are more at risk given persistent cap rate compression and questionable tenant demand.

The same bifurcation applies by geography. Hong Kong, for example, is seen as more at risk because current values for many commercial (and particularly office) properties have fallen even below banks' 50 percent LTV thresholds. There have been rumours of central bank intervention to precipitate a sale in at least one such case. Markets such as Seoul, Sydney, and Melbourne, meanwhile, are seen as somewhat protected from such scrutiny given how far asset prices in those cities have increased in recent years.

Still, exactly how aggressive regional banks become in pursuing default situations remains the key – and probably unknowable – question. Uncertainty over this issue is contributing to market stagnancy as investors opt to hoard cash in case they need it to recapitalise assets, but plenty of industry participants believe banks will simply revert to form and attempt to sit out the storm without moving to enforce significant numbers of technically defaulted loans.

Certainly, overall levels of investor concern do not seem elevated at this point (see exhibit 1-5). Apart from in Hong Kong and Australia, interest rates are not as high as in Western markets, and while occupancy rates lag 2019 levels, they are nowhere near as problematic as in the United States and Europe. As one Singapore-based fund manager observed: "It doesn't feel as if there's pent-up anxiety in the market that's going to make the bottom fall out. The difference between now and the global financial crisis is that the banks [today] are well capitalised, so although they may not agree with valuations on commercial real estate and therefore covenants are being breached – if not

today then in six to 12 months – they aren't going to be as forced to offload [as they were in 2009]."

### Australia and South Korea First to Move

In practice, interviewees saw revaluations occurring first in Australia and South Korea. One reason Australia is in the crosshairs is that its domestic interest rates have risen higher and faster than almost any other regional market. Another reason is that bi-annual mark-to-market adjustments required of Australian REITs (A-REITs) have already served to kick-start the revaluation process, resulting in downward revaluations of up to 10 percent in the first nine months of 2023. Although that probably still underestimates required writedowns given deeper share price declines seen in office A-REITs, it is at least an indicator that the market is moving.

Beyond that, A-REITs are thought to be more open to value adjustments than private-sector peers, given their need to free up capital to fund pre-committed development pipelines. This means further A-REIT sales are likely, according to a Sydney-based fund manager. Australia's unlisted property funds may also become forced sellers, given growing pressure to dispose of assets as investors move to withdraw their capital.

In what may be a sign of things to come, an office tower divested by an A-REIT in the Sydney city fringe in mid-2023 transacted at a reported cap rate of 6.6 percent, representing a 17 percent discount to December 2022 book value. This compares to a probable 5.5 percent cap rate applicable in the pre-COVID market. Although, according to the Sydney fund manager, the sale involved "an idiosyncratic asset that is not really a read-through to high-quality premium offices", the sale goes some way to setting a precedent, if not a firm benchmark.

Nor will sales be restricted to core assets. According to the same fund manager: "There's a subset of the market owned by less-institutional grade managers involving lower-quality assets that are having trouble leasing. They may come under pressure from an ICR covenant perspective because the covenants were set a couple of years ago when interest rates were basically zero, so they're pretty conservative. That's where we think there might be some challenges for current owners and opportunities for acquisitions – that lower-end spectrum and more boutique or non-traditional owners." One such asset that traded in mid-2023 was keenly contested, drawing over 30 individual bids.

South Korea has also seen a repricing trend. Originally, this arose in the logistics

Exhibit 1-6 South Korea Share of Global Office Acquisitions, Q2 2023



Source: MSCI Real Capital Analytics.

sector as a result of oversupply issues. More recently, starting in the second quarter of 2023, the office sector produced a rash of forced sales, accompanied by cap rate expansion of about 75 basis points. A huge US\$3.8 billion of assets was transacted during this episode, according to MSCI, amounting to fully 12 percent of global office volume (and 35 percent of Asia Pacific volume) for the quarter.

The office-distress episode in Seoul is instructive for a couple of reasons. First, it happened despite extremely strong sector fundamentals. Seoul currently has a severe shortage of office space, with vacancies as low as 1 percent, together with good prospects for rental growth. Second, buyers were willing to jump in opportunistically at cap rates that were well below the cost of debt.

According to one investor: “So they buy at a [cap rate of] 4 and finance at 5.5. That means they use negative leverage, but rent growth is strong, so they’re thinking: ‘In three years, if I just mark to market, I might be at a 5 return-on-cost, but if I also get rent growth I might be at a 5.5 to 6, and by then I’ll have positive leverage. And maybe it’ll be even more because in two or three years interest rates might come down.’”

### Long Haircuts or Short?

While revaluations in the Asia Pacific are unlikely to be as steep as in the West, there remains little clarity on where values will eventually settle. This is because, unlike the global financial crisis, the causes are not simply economic (i.e., in this case, interest rates) but also involve structural changes in future demand for space. This applies especially to office assets, and means that value resets will vary widely by both market and asset class.

The experience in South Korea, for example, shows buyers may be willing to accept non-accretive deals even in distress situations as long as they see value accruing over time, whether because deals involve assets that would never otherwise come to market, or

because supply shortages are likely to produce strong rental growth.

Equally, demand may be influenced by lower corporate earnings (as in Hong Kong), or from overbuilding (as in China), or from work-from-home-related demand destruction (as in the West).

This is another reason – apart from perpetually low interest rates – that offices in Japan, where pre-commitments remain high and the residual impact of work-from-home practices seems limited, continue to trade at little if any discount to historical values. In the same way, the ongoing influx of multinational companies looking to establish operations in Singapore has led to tight bid-ask spreads for prospective deals in the office sector, even if few trades took place in 2023.

Meanwhile, the market that remains most off pace in terms of a post-COVID office recovery is Australia, which happens also to be the one where cultural norms (as well as work-from-home practices) are more inclined towards the West. According to CBRE, average CBD vacancies in Australia at the end of the second quarter of 2023 stood at 12.8 percent, the highest level in 25 years.

At the same time, however, because those vacancies were located mainly in smaller and older properties, rather than distributed evenly across CBD buildings, interviewees suggested that revaluations would take effect in a similarly non-linear way, with higher-quality assets benefitting from strong demand and lower repricing pressure. According to two Sydney-based fund managers, the traditional spread of 100 to 150 basis points above Australia’s “long bond” (i.e., the 30-year government bond) should be adopted as a baseline for cap rate repricing of well-tenanted CBD properties, with an additional 50 to 100 basis points for secondary-grade assets. Given that the long bond traded at 4.85 percent as of mid-October 2023, that implies cap rate expansion to between 5.85 to 6.35 percent.

This rough-and-ready estimate of a 150 basis point expansion to yields was also proposed by interviewees in other regional markets, with a likely proposed time frame of 12 to 18 months, during which transactions are likely to remain muted.

Compared with an increase of 400 basis points in the Australian cash rate since April 2022 (and similar rate increases

Exhibit 1-7 **Typical Asia Pacific Bank Commercial Lending Terms**

	LTV	Reference Rate	%*	Spread in Basis Points	Lowest Cost of Debt
Australia	50%	3-Month Bank Bill Swap Rate	4.33	200-225	6.30%
India	75-90%	1-Year Marginal Cost Lending	8.55	150-400	10.00%
Taiwan	50-65%	1-Year Deposit	1.59	60-120	2.20%
Singapore	50-60%	3-Month SORA	3.7	125-175	4.90%
Japan	55-75%	3-Month TIBOR	0.07	70-170	0.80%
Hong Kong SAR	50%	3-Month HIBOR	5.21	150-250	6.70%
Mainland China	40-50%	5-Year Base Lending	4.2	-40-260	3.80%
South Korea	50-60%	3-Month CD	3.93	125-175	5.20%

Sources: CBRE, Trading Economics, State Bank of India, Bank of Taiwan, Monetary Authority of Singapore.  
\* As of 27 October 2023.

elsewhere in the region), a 150 basis point move in yields seems modest.

One reason for this is that banks are in no hurry to set off a waterfall of defaults that would undermine the value of their own collateral or (worse) saddle them with defaulted assets they are then left to manage. In the words of a Hong Kong-based consultant: “Repricing will be somewhat slow because it’s not as if there’s any transactional evidence – it’s all behind-closed-doors and will only come in annual accounts and corporate statements as and when they’re made. One thing banks don’t want is redundant properties – I’ve seen it before where we wanted to throw in the keys and the banks said ‘no way’, even on what might be considered advantageous terms. And obviously these are going to be marginal properties, so you can see why. I think it’s a reflection of the structure of the market – we just aren’t as sophisticated as in the US.”

### China Risk Too High for Foreign Funds

China, meanwhile, remains a wild card. Along with Japan, it remains the only market in the Asia Pacific where interest rates have not increased (they have actually declined), allowing it to maintain a positive yield spread. But the prognosis in most Mainland asset classes remains negative because of a combination of macro weakness, ongoing tumult in the developer sector, and chronic oversupply in both office and retail sectors that is depressing prices and rents. As one investor said, “A polite way to put it is that Shanghai is a tenant-favourable city.”

Given especially the unknown political calculus, projecting where and when pricing will settle is impossible, leaving most foreign investors to sit out the downdraft despite an environment target-rich in distress.

To a great extent, the same applies to Hong Kong, which has been unjustifiably swept into the Mainland China bucket by many global investment funds. Hong Kong has the dubious distinction of

having the highest interest rates, tightest cap rates, and (at least some of) the highest vacancy rates of any market in Asia.

At the same time, although yields remain at implausibly high levels, prices of many assets have declined so much that some fund managers are eying a trade. “If you look at the price per pound, Hong Kong is cheap,” said one investor. “The returns are low because you have high vacancy and low rent, but you have a low basis, it’s relatively cheap compared to where it was, and there’ll be an uptick. So it’s not a bad place to put money so long as you find the right deals and are comfortable with the risk profile.”

### The Pivot to Alternatives

As noted already, staple asset classes such as retail and (especially) office are currently out of favour. One reason for this is the potential for secular shifts in demand for space. Another is that higher interest rates are forcing investors to embrace new strategies. In the words of a Singapore-based fund manager running a private credit strategy: “The question we ask borrowers today is: the days of total returns getting bigger contributions from capital gains are over,

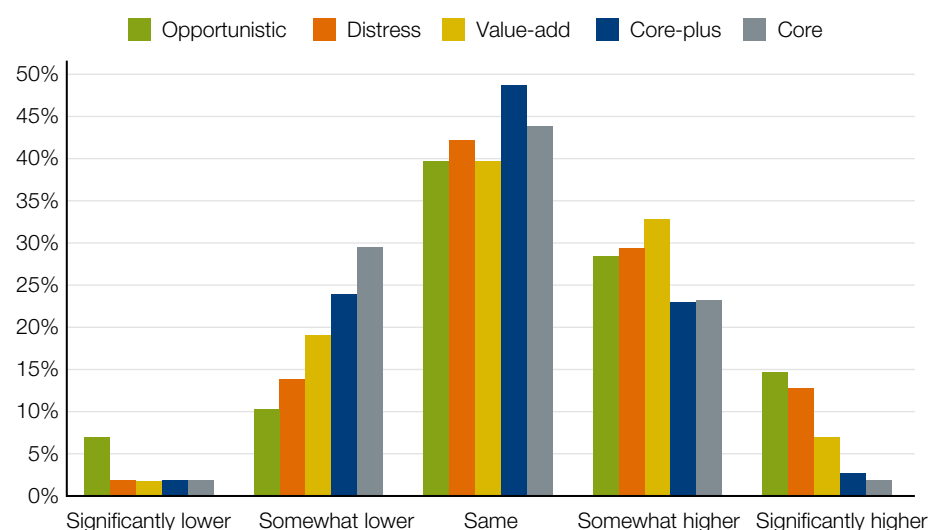
so show us how your asset management is going to work. Interest rates are high, so where is your income growth going to come from in terms of asset management?”

An obvious way to address this is to structure investments using either less debt or no debt at all. While this approach reduces prospects for outsized returns, it can prove key to securing deals where bank financing is either too expensive to satisfy underwriting mandates or is not available at all. As a result, all-equity purchases are becoming more common.

By nature, such deals tend to suit either cash-rich buyers like pension funds and insurance companies, or private-capital syndicates of high-net-worth buyers. According to a fund manager at a large institutional fund: “Sometimes we do pure equity deals: for example, where it’s a distress situation and we want to move quickly. In that case, we wait until the market improves and refinance maybe a year or two later.”

The other way to address the problem is to invest in asset classes that generate higher profits and offer good potential for rental growth. No coincidence, then, that survey responses indicated a significant

Exhibit 1-8 **Change in Targeted Returns Compared with 2023**



Source: *Emerging Trends in Real Estate Asia Pacific 2024* survey.

## Australia: Key Themes

Commercial real estate transaction volumes in Australia fell sharply in 2023, with second quarter volumes registering a decline of 68 percent year-on-year, according to MSCI, the second-lowest quarterly volume since 2011. The main reason for this decline has been that investors have been unwilling to buy large CBD offices, which have historically been the mainstay of institutional investment transactions.

There are various reasons for this lack of deals. Most obviously, the Australian office sector has been subject to the same work-from-home hangover as other global markets, with particular impact on Melbourne, which suffered a harsher lockdown regime than Sydney and has a more domestically focused tenant base. In addition, while cost of debt has increased sharply since mid-2022, with the Australian official cash rate rising to 4.35 percent as of November 2023, asset values and cap rates have yet to make corresponding upward adjustments, leaving investors unwilling or unable to buy because returns are no longer accretive.

Transaction logjams cannot last forever, though, and Australia may be the first in the Asia Pacific to see them break. In part, this is because Australian interest rates have risen faster and higher than any developed market in the region with the exception of Hong Kong, meaning that asset values are more distorted than they are elsewhere. In addition, interviewees expected domestic REITs and unlisted property funds would soon bring properties to market in order to either fund development pipelines or to provide redemptions to shareholders seeking to exit investments. A handful of transactions in the middle of 2023 provided an indication that repricing is in progress, with one asset located in the Sydney city fringe selling at a reported cap rate of 6.6 percent.

Another noteworthy trend has been the shifting composition of buyer types.

## Australian Transactions by Property Type, Q2 2023

	Q2 2023 Volume		H1 2023 Volume	
	\$bn	YOY	\$bn	YOY
Office	1.0	-83%	3.0	-73%
Industrial	2.4	-62%	4.7	-63%
Retail	1.8	-57%	3.4	-68%
All commercial	5.2	-68%	11.1	-68%
Hotel	0.4	-16%	1.5	16%
Apartment	1.4	50%	1.4	39%
Senior housing and care	0.1	-36%	0.2	-72%
Income properties	7.0	-61%	14.2	-62%
Development site	1.7	-50%	2.3	-61%
Grand total	8.7	-59%	16.6	-62%

Source: MSCI Real Capital Analytics.

Note: The apartment/build-to-rent sector comprises multifamily rental properties and includes student housing.

Global institutions, which were previously the dominant player at the core end of the market, were conspicuously absent during the first half of the year, as were local REITs and domestic institutional players. Although there have been anecdotal reports that institutional activity is now picking up, the vacuum has in the meantime been filled by syndicates of high-net-worth capital.

According to one fund manager, “Cash-on-cash returns are negative, so [most funds] cannot invest unless they have a different mandate. That’s why we’re seeing private capital coming in and outbidding institutional investors left and right. They’re very active because they don’t have to borrow, with a lot of deals trading at 100 percent equity. We’re seeing that happen across the board, in all sectors.” Typically, such deals involve smaller lot sizes and have also featured vendor finance (i.e., where the seller lends the buyer part of the purchase price) in cases where the syndicated market has been unable to secure sufficient capital.

With office and retail sectors now out of favour, and development also seen as offering generally poor risk-adjusted

returns, investors are left with a narrow range of options.

The most popular remains logistics, which over several years has grown into arguably the most coveted asset class in Australia. Steady cap rate compression saw prime yields sink under 4 percent as of the end of 2022, and while they rebounded about 50 basis points by mid-2023, sector fundamentals remain positive given chronic undersupply caused partly by shortages of appropriate land and partly by rising construction costs.

On paper, therefore, near-zero vacancies, combined with strong rental growth (averaging 22.8 percent year-on-year in mid-2023, according to JLL) continue to attract investors to industrial assets, subject to pricing and scale of available facilities. According to a manager at a global institutional fund, “Rent growth is still outpacing value decreases from cap rate expansion, so we are still seeing value uplift.” Meanwhile, US\$4.7 billion in transactions during the first half of 2023 made logistics by far the biggest of any asset class in Australia, according to MSCI figures.



At the same time, warning signs of a cyclical peak are emerging. Rising interest rates are complicating deal underwriting, causing the bid-ask spread for industrial properties to balloon significantly wider than for local office assets. In the words of one Sydney-based fund manager: “Perhaps there is very limited vacancy in some of these core key markets, but how can we be comfortable that rental growth will continue to play out, at least in the medium term? The fact that you’re seeing a lot of portfolios come to market now, and you’re also looking at these very institutional industrial developers and fund managers offering interests in funds, is probably writing on the wall that perhaps it’s a story to sell.”

Meanwhile, interest in Australian multifamily development continues to grow, even as the market shies away from development projects generally. This is to some extent a result of the rerouting of capital away from office and retail assets in favour of safe-haven, income-producing sectors – a strategy adopted increasingly by institutional funds pursuing an overarching (and often global) strategy targeting living sectors.

Market fundamentals for build-to-rent plays remain supportive, given ongoing demand generated by rapidly increasing immigration, in tandem with a shortfall of construction activity to supply new housing stock. In addition, the announcement in the first half of 2023 of various tax breaks for the build-to-rent sector has further motivated investors and led to an upswing in new deals. Construction of some 2,500 new units broke ground during the first half of the year, mainly in Melbourne.

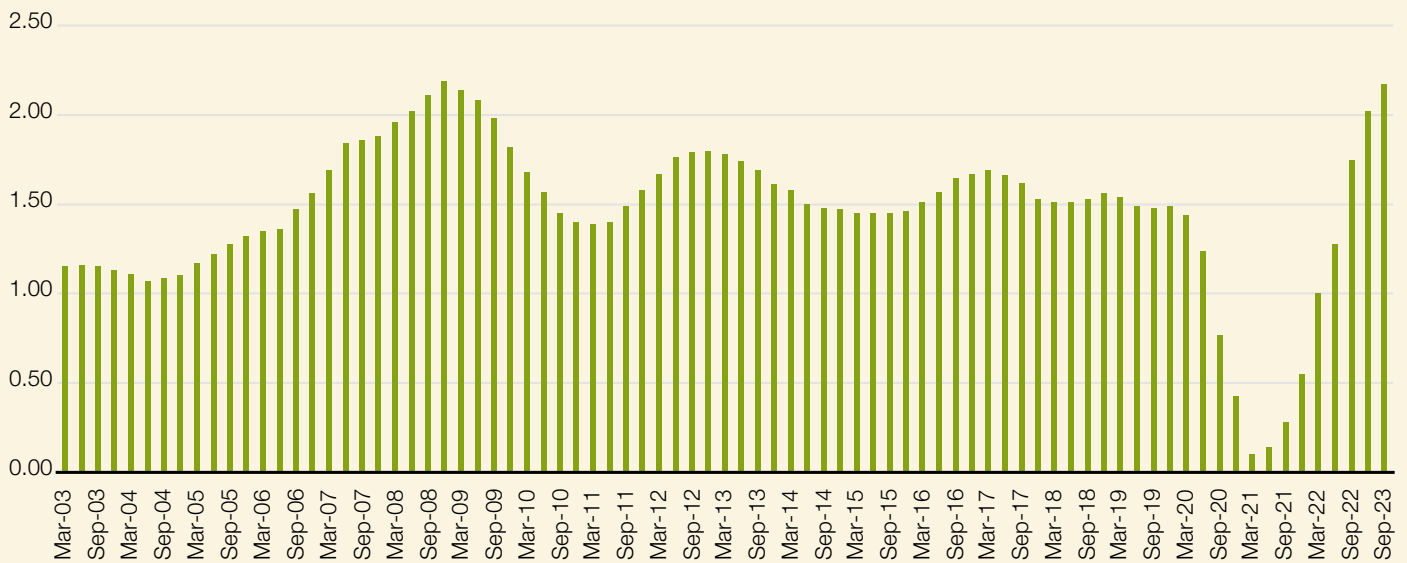
Debate continues, however, as to the economic feasibility of multifamily development in Australia given that high home prices result in low yields that are unlikely to satisfy fund managers’ hurdle rates, at least in the foreseeable future.

Going forward, as more owners are compelled to mark to market their commercial real estate portfolios, interviewees see asset prices continuing to trend down during the first half of 2024. At the same time, although buying should see a corresponding pickup, the level of activity is likely to remain suppressed compared to historical norms.

There are a number of reasons for this: bid-ask spreads remain among the highest in the Asia Pacific, fundamentals are soft (with vacancies and incentives elevated), and the majority of domestic and global institutional players are likely to remain on the sidelines until interest rates stabilise and there is more clarity to the macro-economic backdrop, both globally and domestically.

“Therefore, it goes back to flight to quality,” said one fund manager. “You don’t want to buy grade B assets or peripheral locations, because the rental gap will widen between highly-rated and lower-rated assets, which means the valuation gap will also widen. Also, I think you’ll see further divestment by debt-laden owners of real estate, and you may get pricing discounts because people will be forced to reduce gearing ratios and interest expenses. On that basis, if you get a discount today, maybe in three to five years’ time, when the long-term interest rate yield curve looks a bit more stable, you can arbitrage and sell.”

**Australia Annual Population Change, March 2003 - March 2023 (year-over-year percentage change)**



Source: Australian Bureau of Statistics: National, state and territory population March 2023.

increase in investors targeting “somewhat higher” or “significantly higher” returns for opportunistic, distress, and value-add deals (see exhibit 1-8). In the past, the industrial/logistics sector played this high-growth, high-return role, leading to its emergence as a major asset class. In fact, with some US\$8.3 billion in trades during the third quarter of 2023, it surpassed even offices to become the largest asset class regionally (see exhibit 1-9). Today, however, while demand remains strong and markets are still generally undersupplied, cap rates for logistics assets have compressed so much that many investors are wary of pushing the envelope further.

The spotlight is turning, therefore, to alternative asset classes that offer a lower base and with better long-term growth potential. Alternatives have been a growing theme in the Asia Pacific since at least 2019, and although they are no longer the preserve of global funds (as local investors increasingly jump in), activity remains well behind levels in the West, where they are collectively almost a mainstream asset class in themselves.

While the concept of alternative investing can mean different things to different people, it generally embodies several key features. Most importantly, it aims to ride tailwinds generated by new technological, demographic, or social trends that are uncorrelated to macro-economic fluctuations. In addition, it may offer features – such as short weighted average lease expiries (WALEs) – that protect against inflation. Beyond that, it tends to involve an operational component that generates profit beyond returns from pure real estate.

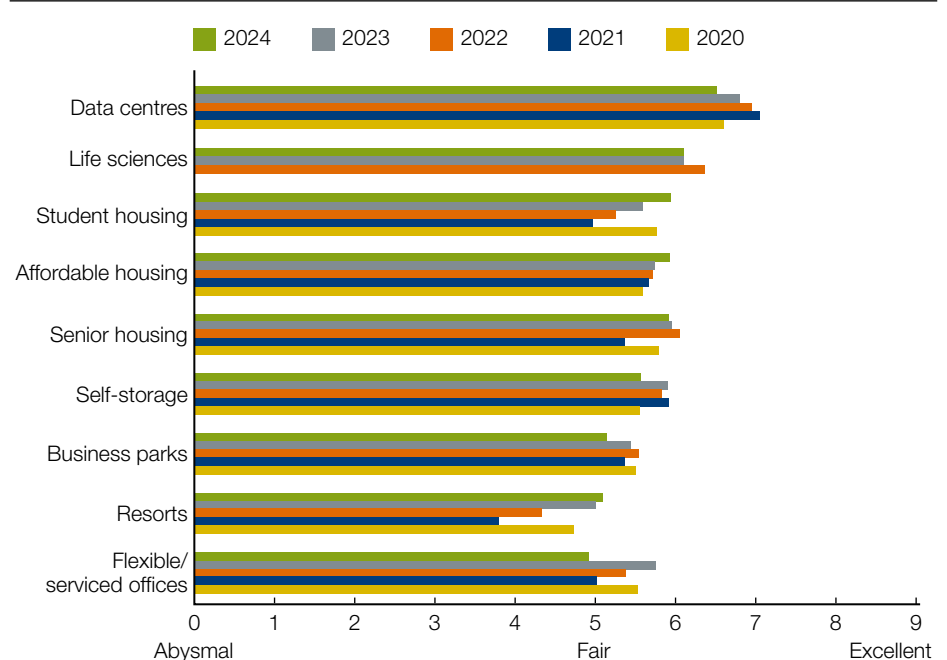
These operational overlays can accrue significant enterprise value in their own right, and are at times bought and sold entirely separately from the real estate entity to which they are attached (such as a hotel). According to a Sydney-based fund manager: “It feels as if the industry is evolving into quasi-private equity, where we’re not just doing the bricks and mortar and valuing a lease income stream anymore. Today, it’s about

Exhibit 1-9 Transaction Volume by Property Type, 3Q 2023

	Q3 2023 Volume		YTD 2023 Volume	
	\$b	YOY	\$b	YOY
Office	7.9	-54%	31.8	-51%
Industrial	8.3	-27%	24.9	-31%
Retail	4.1	-27%	19.3	-29%
All commercial	20.4	-41%	76.0	-41%
Hotel	3.2	-7%	9.4	-26%
Apartment	2.0	-13%	8.7	1%
Seniors housing and care	0.1	-91%	0.9	-58%
Income properties	25.7	-37%	95.0	-37%
Development site	118.8	-33%	315.2	-29%
<b>Grand Total</b>	<b>144.5</b>	<b>-34%</b>	<b>410.2</b>	<b>-31%</b>

Source: MSCI Real Capital Analytics.

Exhibit 1-10 Prospects for Niche Property Types



Source: Emerging Trends in Real Estate Asia Pacific surveys.

really understanding the management company and the entities and the HR policies and the design and the branding and all this other stuff that was previously left to others to think about.”

A final characteristic of alternative assets is that they offer the possibility of early entry to emerging industries, where competition is thin and growth

prospects can be explosive. Only a few years ago, data centres were considered by most real estate investors to be a bridge too far, because their operational characteristics required investors also manage a complicated non-real estate business featuring a variety of hard-to-quantify risks. In the end, however, first movers profited handsomely in what quickly became a booming industry.

Today, investors actively seek out prospective new alternatives in search of the next home run, with several interviewees this year expressing interest in sometimes obscure early-stage opportunities ranging from film studios to semiconductor manufacturing parks.

## Operational Challenges

While the focus on alternatives seems for now to match (if not at times eclipse) interest in traditional asset classes, and may continue to do so at least until adequate yield spreads are re-established, there are also significant challenges. As one Australian fund manager observed: “A lot of people will see the opportunity and want to get their portfolios exposed to those tailwinds of demand, but actually executing on it is tough, and the operational risk is high. The hope is for rental growth, which should come, but for now the cap rates are pretty tight.”

One risk is that few fund managers have relevant experience in what are often esoteric fields, meaning they usually need to bring in outside expertise. Depending on fund size and/or investment scale, this translates either to hiring qualified staff, buying an existing service company, or establishing a joint venture.

Because any of these options requires significant investment both financially and in terms of human resources, investing in operationally intensive assets tends to favour large funds that can centralise recruitment of incoming expertise, which they often do on a global basis. Quite apart from generating operational efficiencies, this strategy allows regionally based investors to import best-in-class know-how that is otherwise lacking in the domestic market. In this way, they are often able to obtain an edge for themselves while simultaneously boosting standards in the local industry.

According to a Tokyo-based fund manager: “With these operational assets, it takes time to build out an entire team [locally], so you certainly think about bringing in operational expertise from

another part of the platform, or from another market. And data centres here have been the same – a lot of the leading players were initially non-Japanese, but the really modern data centre business has been built by others from abroad.”

While this generates obvious upside for returns, it also creates another layer of complexity. “It’s a higher value-add kind of real estate,” continued the investor, “but one of the challenges if you’re an early mover is: How does the Japanese market digest these properties? They’re operationally excellent, but at the same time, it’s not like anyone out there knows how to manage them. So how much liquidity do you need for that asset, and how do the banks finance that? Those are challenges you face as an early mover.”

Another challenge for alternatives is the difficulty in achieving scale, which is necessary both to maximise efficiency and to build portfolios big enough to institutionalise. Although they can grow quickly, almost by definition alternative asset classes are products of emerging business models that have yet to gain real traction, and therefore lack a critical mass of stabilised assets. According to an investor in Australia: “If you’re looking for life science portfolios of scale, they don’t really exist here, so you’ve got to build them up. And self-storage is similar – we have a couple of big portfolios, but then there [are] lots of fragmented mum and dad ownerships too. Which is an opportunity in itself, but it’s a pretty specific approach that’s needed to build up to portfolio scale.”

Even where an alternative asset class has grown to substantial size, as with the multifamily sector in Japan, an overarching shortage of stabilised assets can leave investors scrambling to cobble together a portfolio by aggregating a collection of smaller assets.

This approach can create problems, however. First, it erodes profitability, given that each component comes with its own baseline of operational costs that undermine prospects for economies of scale. Second, portfolios assembled in such an enforced and piecemeal

way can suffer from poor asset quality. As an example, an investor in Japan noted a recent strategy adopted by foreign investors looking to assemble a multifamily portfolio by aggregating a number of newly developed four-storey wooden walk-ups. Once assembled, however, the portfolio proved difficult to sell because local buyers took exception to the format and quality. “You’re never going to get rent growth for this stuff, because it deteriorates quickly, and anyway people don’t want to live in a four-storey walk-up,” said the investor. “So they’re aggressively priced, but there are no bids.”

A final risk factor is that market prospects can vary radically from place to place. The fact that a given alternative has gained critical mass in one jurisdiction is therefore no guarantee it will succeed in others. This is why prospects for Australia’s nascent build-to-rent sector, where yields are extremely tight and cultural resistance to the institutionalisation of home rentals is common, remains controversial.

## Investors Shun Development Risk

When interest rates were low, development on a build-to-core basis came to be seen as a good way to bypass excessive competition for stabilised assets. Not only were development loans cheap, but a profitable exit for completed products was often assured, given chronic structural undersupply of investment-grade products and a mountain of dry powder looking for a home.

Today, prospects for development have shifted. On the one hand, underwriting is difficult because of uncertain end-user demand and uncertainty over cap rate movements. On the other, construction costs continue to rise as a result of both materials and (especially) labour shortages. One reason for this, according to a Singapore-based interviewee, may be a surge in demand for skilled workers in Saudi Arabia, where an enormous spate of construction

### China: Key Themes

Although higher-than-expected 4.9 percent year-on-year GDP growth in the third quarter of 2023 hints at early signs of a rebound, China's economy remains weighed down by accumulated debt and ongoing challenges in the housing sector.

In the past, authorities were able to manage property industry fundamentals by easing or tightening measures implemented by the central government, keeping the wheels turning while working in the background to mitigate excesses. Today, however, the steep financial losses incurred by consumers and businesses over the past three years make this strategy less feasible. Faced with a bank-lending squeeze on one hand and bearish market sentiment on the other, developer defaults have continued in 2023, with repercussions felt throughout the economy.

According to an August 2023 report by investment bank Goldman Sachs, developer indebtedness at the end of 2022 totalled some Rmb19 trillion (US\$2.6 trillion), or 16 percent of GDP, about 75 percent of which is owed to domestic banks. On the basis that 10 percent of this will prove irrecoverable, Goldman Sachs concluded that “the concentration of potential losses within banks indicates why a comprehensive restructuring of China property debts could require recapitalisation for certain segments of China's banking sector.”

At the same time, however, the oft-quoted idea that China is now facing a debt crisis is misconceived. While the amount of both known and latent debt is surely large, little of it is denominated in foreign currency, and the economy – in particular the banking sector – is structured in ways that give policy makers more direct control of the levers of growth than in the West.

In the words of one locally based fund manager: “The structure of financial plumbing in China is just different, and it provides policy makers a number of

additional tools. So, if a Chinese state-owned bank is lending to a Chinese state-owned enterprise, even though there's an interest rate and a maturity date associated with that instrument, fundamentally it's equity if the central bank wants it to be – that's not the case in markets like the US.”

In September 2023, authorities introduced a range of measures that aim to boost demand for home buying, including increased bank lending, an easing of restrictions on home purchases in core cities, and lower mortgage rates and downpayment ratios for first-time homebuyers.

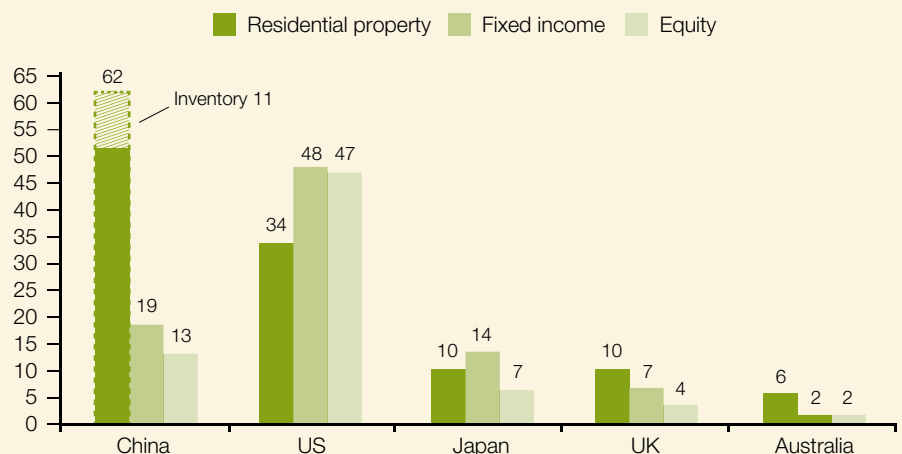
However, according to some economists, if China's command economy thereby affords it support against economic downside, its rigidity also functions to limit its upside, making a stimulus reboot more difficult than in the past. For more than 30 years, infrastructure and real estate investment served the country well as the main engine for economic growth, boosting productivity and creating millions of jobs. But as the economy has matured, so the scope for further productivity gains achieved in this way has shrunk, and with it the incremental boost to GDP of each dollar of stimulus invested.

As a result, many economists believe that China faces a choice: either it accepts that old-style stimulus will yield diminishing returns, or it addresses imbalances by steering the economy more in the direction of consumer spending (which plateaued in 2016 at 38 percent of GDP, compared with 60 percent in the United States). Whether such a policy shift is feasible remains unknown.

Meanwhile, local property sectors show few signs of rebounding. In particular, developer liquidity issues, originally confined to residential players, have spread to the commercial real estate sector. Access to bank lending is therefore limited, and developers are anyway reluctant to invest while deflationary pressures persist. Commercial real estate transaction volume in China dropped by 25 percent year-on-year in the first nine months of 2023, according to MSCI.

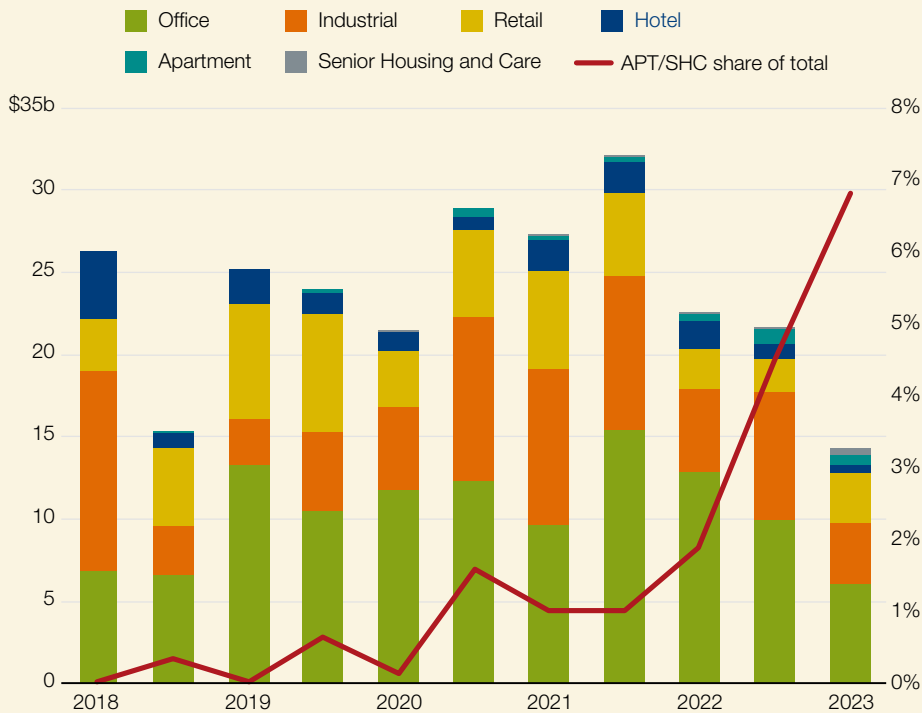
In previous years, the absence of local competition would have been a golden ticket for international investors to seize the initiative. Not only are increasing numbers of distressed properties coming to market, but falling interest rates have made financing deals cheaper, with the Mainland currently the only market in Asia other than Japan able to provide a positive spread over the cost of debt. As

### Comparative Size of Global Real Estate Asset Classes



Sources: Bloomberg, Citi Research estimates.

## China Investment Volumes by Sector



Source: MSCI Real Capital Analytics.

one investor commented, “This is the first time in the past 15 to 20 years when we’ve seen Shanghai office in positive-carry territory.”

In current circumstances, however, most international funds have opted for now to step back from the market. In the words of one experienced China operator: “A number of institutions we work with have a zero-China policy for any new investments, no matter what the deal is, or what the returns may be.”

However, a minority of foreign investors remains willing to deploy capital. Apart from the large global opportunistic players, interested parties include those with established in-country operations (especially from Singapore), as well as sovereign funds from the Middle East.

For them, as in other markets, the spotlight has fallen on non-traditional

asset classes. Logistics properties have gained attention, given the structural undersupply of modern infrastructure.

Even more popular is the build-to-rent housing sector, whose share as a proportion of total commercial real estate investment in China has soared since the beginning of 2022 (see chart above). According to a Hong Kong-based fund manager, “It’s too early perhaps at the moment, but multifamily in Shanghai and possibly Beijing could be interesting. If you don’t have the country risk concern and the geopolitical concern, which about 90 percent of [US dollar] investors do, but from a purely property perspective – [there is] strong government support for long-term residential-for-rent [properties].”

Future growth of the multifamily sector is supported by various factors, including a large floating population of young workers in China’s tier 1 cities, government

support in the form of favourable zoning rules, and a favourable exit strategy through sales to China’s new housing REITs or other domestic institutional buyers.

Meanwhile, investors can readily obtain leverage from onshore banks. According to one foreign fund manager: “The only way to play China now is with domestic renminbi capital, because [local sources of funding] don’t price-in the country risk the way offshore investors do. There are a couple of good multifamily developers out there – you could either buy and operate, partner with them to capitalise their development pipeline, or use them to get access to attractive sites from for-sale residential developers in need of liquidity.”

That said, with local banks reluctant to call in defaults, asset prices have been slow to adjust, despite ongoing challenges across the developer space. Even foreign investors willing to deploy capital are therefore left on the sidelines waiting for valuations to adjust, stress or distress to increase, and/or for end-user confidence to return in the form of rising occupancy and new leasing.

On a positive note, however, expectations remain high that those opportunities will emerge in the medium-to-long term. As one fund manager said: “In the past, we had found China, outside a couple of very specific sectors, difficult. We didn’t like the residential sector since 2013, we never really liked the office sector because supply just keeps coming, and then logistics is very sub-market specific. But I think of it now as one big reset, and we’re of the view that it will be some of the best vintage investing in the next couple of years. The reality is that geopolitical factors mean it’s not going to be for everybody, but in a weird way I’m more excited about China now than I was pre-COVID.”

projects “is sucking up people and resources from everywhere. Half the development managers we know have ended up in Riyadh, which has a knock-on effect through the development market because there’s a lot of overlap between Asia and the Middle East.”

One consequence of the current reluctance to pursue development strategies is that supply pipelines are shrinking. In addition, significant numbers of planned or in-progress development projects are said to be in limbo due to a combination of higher financing and construction costs.

In markets where demand is already tight, therefore, space will become tighter, which in turn should help support prices. As one Singapore-based fund manager said: “At the moment, the development map is challenging given where interest rates and commodity input prices are, which suggests you’re in more of a buy-versus-build market. In particular, when we look at the Seoul market, there is effectively zero high-quality new product being delivered over the next three years, which means it’s going to be a great market to be a landlord.”

Another consequence is that land prices are dropping in line with declining demand, with an investor in Japan noting existing downward revisions of around 10 to 15 percent, and others suggesting further price cuts are on the way.

Still, while development has slowed, projects where demand is likely to be strong continue to receive funding. This includes, very often, projects involving alternative asset classes. Japanese multifamily projects, for example, were repeatedly mentioned as targets for development due to strong demand for new product of a certain type.

According to one fund manager: “In Japan, construction cost inflation has perhaps been less than in other markets in the region, and with our team on the ground, and the way we structure transactions with development partners, we have more confidence we can de-risk that construction cost risk by

early contractor engagement. Also, development timelines are shorter and planning processes are clearer, so you’re able to underwrite that construction cost risk with more certainty.”

### Migrating to Quality

In pre-pandemic times, design and use of CBD buildings was often informed by backward-looking norms rather than an ambition to blaze a trail by building sophisticated and user-friendly facilities. In both architectural and place-making terms, therefore, city centres were often conventional and unimaginative.

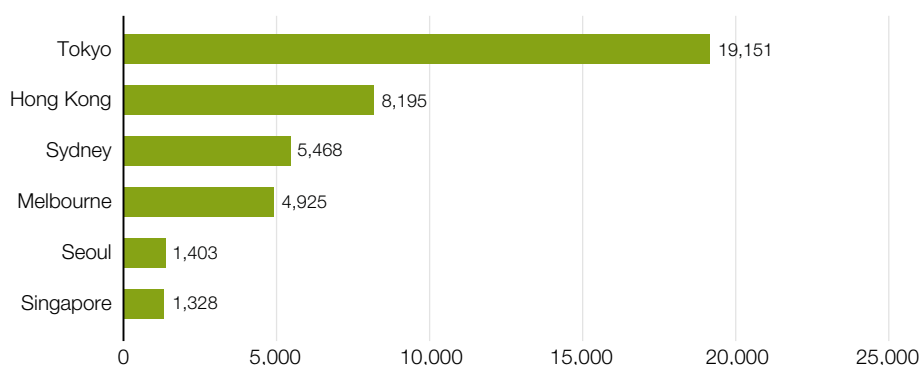
But as work-from-home mandates emptied out city centres and workers became accustomed to more independent lifestyles, the balance of power has shifted. With office occupancy in most markets still lagging (though not as badly as in the West), employers and building owners are seeking to nurture return-to-office mentalities by reimagining or upgrading their workspaces. As a result, amenities offered by high quality CBD office buildings have dramatically improved, with wellness, food and beverage, flex working, and end-of-trip facilities becoming standard. Energy efficiency is another key metric. As one investor said: “Increasingly, ESG [environmental, social, and governance] requirements are so systemic in people’s conversations that if you’re a big occupier

you just don’t want to look unless stock has been built in the last 10 years.”

While these improvements are a bonus in terms of usability, upgrade cycles have at times morphed into a design-driven arms race, as landlords and employers seek to out-compete peers in order to incentivise both returning and new workers. High vacancy rates in most CBDs have now turned this into a zero-sum game, where buildings unable to compete in terms of either location or facilities lose out. As occupiers increasingly migrate to higher-quality buildings, low utilisation rates now fall disproportionately to have-not buildings that lack requisite modern standards.

The end result of this process, as tenants continue to flee second-tier and poorly located buildings, will be a glut of under-used office stock that will eventually require repurposing. Upgrading as part of a value-add play may be one way to address this, although with lower density in CBDs now a seemingly secular trend, upgrades may not prove economic. Another possibility lies in residential conversions. The strategy has obvious appeal in the Asia Pacific, given chronic shortages of housing stock, especially in city cores. Singapore, for example, has initiated a CBD Incentive Scheme, whereby developers receive an additional 25 to 30 percent of developable area for conversion of office buildings older than 20 years to residential or hotel purposes.

Exhibit 1-11 Potential New Housing Stock from Office-to-Residential Conversion



Source: JLL  
 Note: Notional number of residential units created from office-to-residential conversion. Based on CBD assets 30 years or older.

But while such conversions have become popular in the United States, where large swathes of newly redundant office space have accumulated, in the Asia Pacific many grade B assets are unsuited to conversion due to their age, small floor plates, low ceilings, or inappropriate construction methods. In general, too, a lack of design flexibility in many existing buildings will prevent repurposing for future uses.

According to a fund manager in Tokyo: “Bifurcation is starting to happen, and ESG is a driving component of that, especially for office. But a lot of these older B-class assets will be untradeable, so if institutions won’t be able to buy them, can you convert to residential? It’s not going to be easy with some of the smaller stuff – you just don’t have big enough floor plates or the right plumbing. I know a number of managers that are looking at office-to-residential conversion, but as far as I can see no one’s been able to pencil to make it work.”

In the end, therefore, this means that assets will probably be bought for land value and then redeveloped, especially if surrounding land can be aggregated to create a single large parcel. In principle, government incentives could facilitate this, but it will always remain a sub-optimal outcome due to the embodied carbon contained in the existing buildings. In addition, it is likely to prove challenging in practice, given the typically diverse land ownership bases and small land packages found in Asian cities.

An even bigger challenge is posed by government planning regulations, which in most markets (with some notable exceptions) are well behind the curve in facilitating implementation of building conversion programmes. According to a consultant based in Hong Kong: “Many of these buildings were built 30 to 40 years ago, and adapting them is physically possible, but not within the rules regime we have at the moment. Rules tend to be rigid and prescriptive, and the ability to change buildings from one use to another is challenging, whereas it should just rely on fire and safety considerations.”

## Emerging Markets Lure Manufacturers

As global geopolitical tensions escalate, the trend for foreign investors to diversify manufacturing bases away from China has accelerated. This results partly from the well-established “China Plus One” factor, and partly from an increasing tendency for international buyers – especially tech-related producers – to require manufacturing outside of China.

While this outflow of manufacturers is very real, the vast depth of China’s industrial base and its accompanying infrastructure makes any divestment an incrementally slow process. This is probably just as well, because even if the volume of outgoing capacity remains tiny by Chinese standards, it is very large relative to the economies of the markets – mainly in Southeast Asia – to which most of this capacity is headed.

In particular, Thailand and Malaysia are absorbing new Chinese technology-related production, while Indonesia’s low labour costs are drawing significant amounts of large-scale manufacturing, especially from the electric vehicle sector.

Meanwhile, the market that continues to benefit most from outward seepage of Chinese manufacturing capacity is Vietnam. Although its economy has lagged recently following a government crackdown on issuance of new debt to domestic developers, Vietnam offers enduring advantages to incoming manufacturers in terms of government support for foreign investment, a willing workforce, and a growing network of supply chain infrastructure.

More important, according to a foreign fund manager active in the country, “When you drill down to manufacturing, it’s because of the [physical] linkage to China. We are more focused on industrial and factory than we are with logistics, but the advantage we think Vietnam has [over its competitors] is that northern Vietnam is effectively just a southern province of China from a transport point of view. And we have seen from our customers that you can [therefore] have a very managed

adjustment of the supply chain that is less disruptive than, for example, going to India or even Thailand/Indonesia.”

For this reason, much of the recent activity by foreign investors creating new industrial capacity – mostly in the form of ready-built factories – has been focused in northern Vietnam, with the south more oriented to satisfying growing domestic demand. Because infrastructure in the north remains relatively less developed, investors must often act as solutions providers for tenants, with a view to addressing numerous bureaucratic and operational challenges.

Another problem, in both Vietnam and Southeast Asian markets generally, lies in identifying investment opportunities that are capable of moving the needle for large investment funds. “It’s a bit of so what?”, said one fund manager. “There’s this great opportunity, but as GPs [general partners] we are trying to put capital to work, and how can we do that? We’ve found, apart from data centres – which are very big assets that require a lot of capital – that in logistics and industrial it’s a lot of small pieces.”

One way to address this problem is by turning to India, which can offer critical mass in terms of both manufacturing capacity and its domestic market. Historically, most foreign investment in India has been directed at office campuses, especially in the business process outsourcing space. But inbound investment is now increasingly seeking opportunities in industrial properties, as the government rolls out incentive programmes and large-scale manufacturers seek new bases.

“The challenge with Vietnam is that it’s a pure export play,” said a Hong Kong-based fund manager. “Whereas in India, it’s a two-fer – it’s like China in the old days; you’re manufacturing for local as well as export demand.” Foreign investment in India has been hindered in recent years as authorities struggle to implement a string of regulatory initiatives, ranging from demonetisation policies, to taxation reform, to development-sector crackdowns. There is a growing feeling among foreign investors, however, that

## Japan: Key Themes

As global investment flows to Asia Pacific real estate dried up in 2023, Japan remained the sole major market to enjoy widespread popularity among inbound institutional investors, albeit at reduced levels compared to previous years. As one fund manager said: “For international investors to pull the trigger, it’s pretty much all [going to] Japan and, selectively, India.”

There is a variety of reasons for this ongoing positivity:

- Capital is rotating away from China, while interest in Australia is also lagging because of high interest rates and widespread reluctance to reprice assets. Global investors with allocations to the region therefore have few alternatives that can meet their underwriting criteria.
- Described by one interviewee as “one of the last bastions of positive carry”, Japan continues to offer ultra-low commercial lending terms of 80 basis points or less. Leverage is also widely available. With deals continuing to offer a positive spread over the cost of debt, there is therefore little pressure for asset values to reprice significantly.
- After 18 months of depreciation, in November 2023 the yen was trading well below its historical norm. This has led many investors to believe that US dollar/yen levels would eventually revert to the mean, providing a significant currency dividend to real estate returns.
- Japan’s corporate sector is undergoing a long-awaited renaissance. As boardroom reforms lead to more enlightened policies on issues ranging from staff diversity, to share buybacks, to employee pay rises, increased efficiency is translating to higher profits, with Japanese earnings per share growing at an annual compound rate of 10 percent in the first half of 2023. Share prices have followed

suit, and many expect wage growth – a precursor of both higher consumption and landlord pricing power – will follow. Another by-product of corporate reform is that it encourages Japanese companies to spin off non-core holdings of real estate (often consisting of underused tracts of industrial land), which can then be recycled into more effective purposes such as logistics facilities or specialised manufacturing-related research and development space.

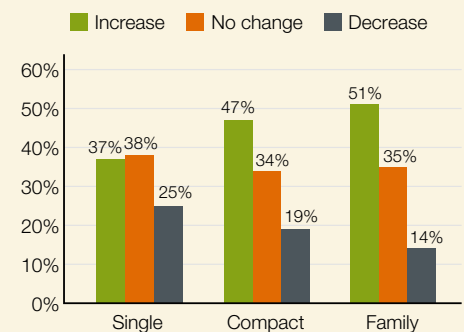
As in other markets, foreign investors are largely avoiding traditional asset classes, even if their fundamentals are relatively strong. As one fund manager said: “You can’t get foreigners to touch office, though the domestic guys still love it because the market itself is still performing well – there are some pockets of vacancy, maybe 8 to 9 percent on average, but it’s nothing like [as bad as] markets in the US or Europe.”

New office supply arriving in 2024 will pressure rents of top-end buildings. But these assets rarely trade anyway, while smaller grade A and grade B offices of the type favoured by Japan’s small- and medium-sized companies are less likely to see occupancy fall due to robust business trends and their limited embrace of work-from-home cultures.

Once again, the focus has therefore fallen increasingly on alternatives. Apart from the beaten-down hotel sector, multifamily assets continue to attract capital. As the only established build-to-rent market in the Asia Pacific, Japan has for several years drawn global institutional investors looking both to diversify their holdings and to increase exposure to an asset class that ticks the boxes for long-term, steady-income portfolios. So far, their investments have proven successful, pushing cap rates as low as 3 percent.

Going forward, demographic trends continue to favour multifamily projects, as workers increasingly return to central Tokyo in a post-COVID population migration. As part of this, demand for

**Year-on-Year Change in Tokyo Residential Rent by Apartment Size (as of August 2023)**



Source: Haseko Livenet.

work-from-home functionality is high, driving demand for larger rental units that include home office functionality.

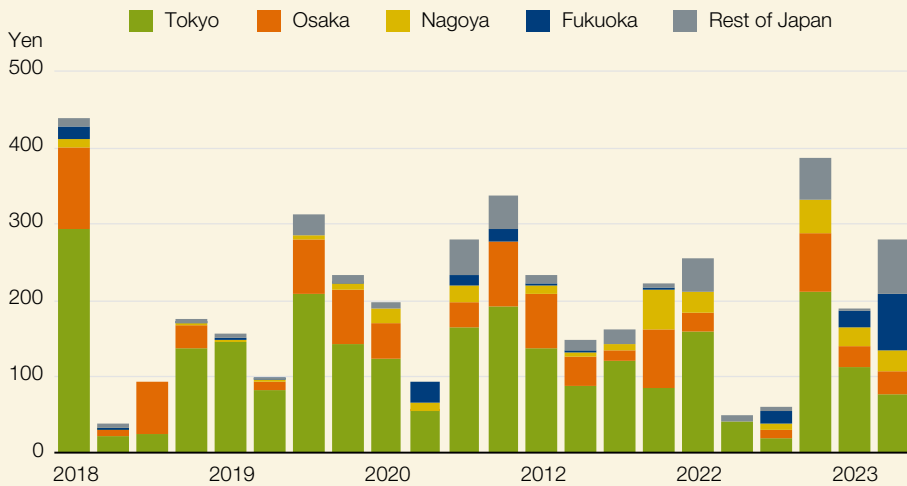
At the same time, with multifamily cap rates compressed so low, investors have become wary. The potential for domestic rate hikes is an ever-present threat in light of the government’s shifting fiscal policies, while others think the sector may have passed its peak. Investment momentum has softened during 2023, partly for the above reasons, and partly because some foreign institutional investors have withdrawn to their home markets.

Otherwise, strong demand for industrial assets has been underpinned by a chronic shortage of modern warehouse facilities, with recent increases in rental growth creating additional sectoral tailwinds. Another factor boosting demand is a recent wave of reshoring by Japanese manufacturers, especially from China. According to one interviewee, this applies in particular to the semiconductor industry, which is bringing with it an entire supply chain of subsidiary and support industries. Transaction volumes for industrial assets have remained high since the final quarter of 2022 (see graphic on next page).

Despite Japan’s enduring popularity, however, the market retains significant downside risk. For one, highly compressed cap rates across the



### Japan Industrial Deal Volumes, 1H 2023



Source: MSCI Real Capital Analytics.

board mean that any increase in rates would result in a painful round of asset revaluations, especially where deals are highly leveraged.

The other side of the monetary policy coin is that, if rates do not rise, the yen will see continuing pressure to depreciate

due to the widening differential between Japanese and global rates, with negative implications for US dollar-denominated investments.

Parsing future currency and interest rate moves is difficult, however. Pressure on the yen would probably ease if (as some

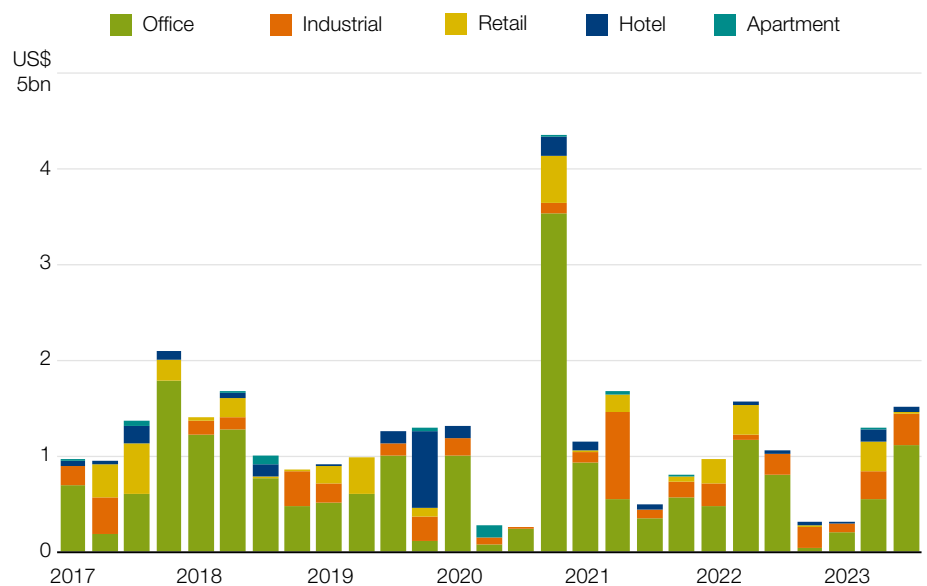
expect) interest rates in the United States peak. Besides this, investors currently have the option to hedge currency risk at highly favourable rates – according to one locally based fund manager, US dollar/yen hedges are actually accretive to real estate deals by as much as 400 basis points.

Still, the unanimity of the consensus over Japan leaves inbound investors clustered on the same side of a boat in some very turbulent waters. Nor is every investor bullish. According to one Hong Kong-based fund manager: “Japan has all the hallmarks of the other markets that have repriced – it’s highly transparent, well developed, highly geared, and very office centric. It hasn’t repriced because interest rates are still heavily controlled by the central bank, but it comes back to whether they can keep interest rates low, because where those cap rates are, just a 25 basis point shift can be pretty monumental as a percentage. So it doesn’t take a lot to disturb the balance.”

“a lot of that stuff has now been done, and it’s put in place a base level of infrastructure that is really helpful for the economy to grow off”. Transaction volumes in India remained relatively strong in 2023, with US\$1.5 billion recorded in the third quarter, according to MSCI (exhibit 1-12).

What’s more, the flow of outbound manufacturing capacity from China seems unlikely to subside given that, as several interviewees noted, demand for industrial space in emerging market economies is originating increasingly from domestic Mainland producers, rather than from foreign companies, as in the past. This is caused, according to the Hong Kong fund manager, by Chinese companies needing to create new space for expansion. “Their customers are insisting they do it,” he said, “but once this starts to happen it’s not going to reverse – our house view is that there

### Exhibit 1-12 Investment Volumes in India by Sector (Quarterly volumes), 3Q 2023



Source: MSCI Real Capital Analytics.

is probably 20 to 30 percent of supply chain transformation that will come out of China as a result of diversification that just won't go back."

### Energy Intensity Gains Traction

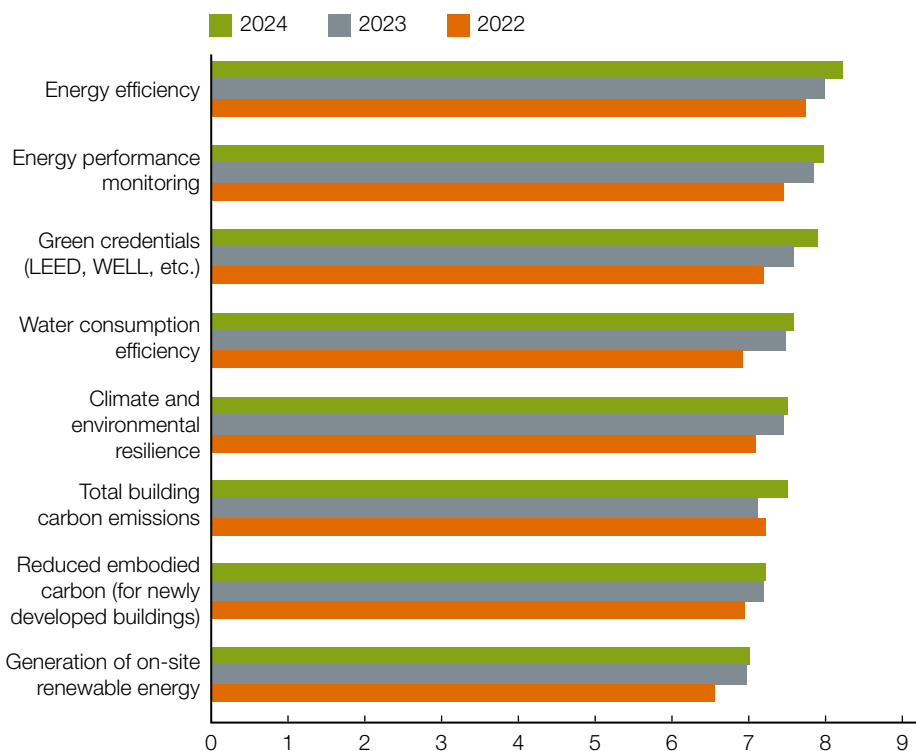
In Asia Pacific's developed markets, ESG issues have become a front-and-centre consideration for both owners and investors. Of the three criteria, governance continues to lag (being mainly of interest to bond investors), while social considerations are starting to make inroads (primarily in relation to wellness issues). As in previous years, however, investor attention remains focused mainly on environmental issues, with agendas going forward increasingly gravitating towards the thorny question of energy intensity.

Energy intensity issues have gained momentum so rapidly because market forces are now driving home to both owners and investors the threat posed by transition risk – a collection of factors that threaten to make non-compliant buildings obsolete over the long term.

Transition risk can come in various forms:

- First, as a result of increasing numbers of investors, led originally by European institutional funds, who are compelled by stakeholder mandates to prioritise carbon efficiency when purchasing assets. As a result, buildings with low energy efficiency are less likely to make the cut.
- Second, because prospective tenants looking to boost employee retention and recruitment will often arrive with checklists to assess sustainability performance and are less likely to take leases in buildings that do not meet their targets.
- Third, because of the real prospect of regulatory reform along the lines of new frameworks coming into effect in Europe and the United States that may compel

Exhibit 1-13 Most Important Green Building Criteria



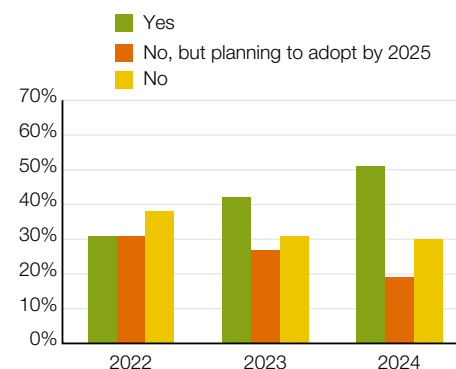
Source: Emerging Trends in Real Estate Asia Pacific surveys.

compliance on pain of severe penalties. According to a US-based sustainability expert, the impact of ever-tightening energy efficiency and environmental standards in countries such as Germany and the UK, for example, will mean that "if you can't meet the standard eventually then you will not be able to have a certificate of occupancy for those buildings. And if you can't have a certificate of occupancy, you can't have debt, you may lose your tenants because they'll have cause to break their lease, and you can't insure your property. So those properties will quickly become worth very much less than they were before they experienced that change." It is probably only a matter of time before similar regulations are introduced in the Asia Pacific.

A study by CBRE published in December 2022 compared various Asia Pacific

markets and concluded that Japan was the only one to rank as a "transition leader", due to its advanced technology, comprehensive infrastructure, and high awareness. South Korea also ranked highly. In terms specifically of commercial

Exhibit 1-14 Proportion of Respondents With Net Zero Carbon Emissions Targets



Source: Emerging Trends in Real Estate Asia Pacific surveys.

real estate, however, other regional markets such as Singapore and (especially) Australia are better known for both private- and public-sector commitment to improving energy efficiency in the built environment.

Still, while transition risk has become a crucial consideration for both foreign investors and building owners, the currently precarious state of the global economy, together with growing investor anxiety over declining asset values and rising construction costs, has seen asset owners dialling down carbon efficiency agendas as they focus for the time being on ensuring they are able to get assets refinanced while also delivering targeted returns.

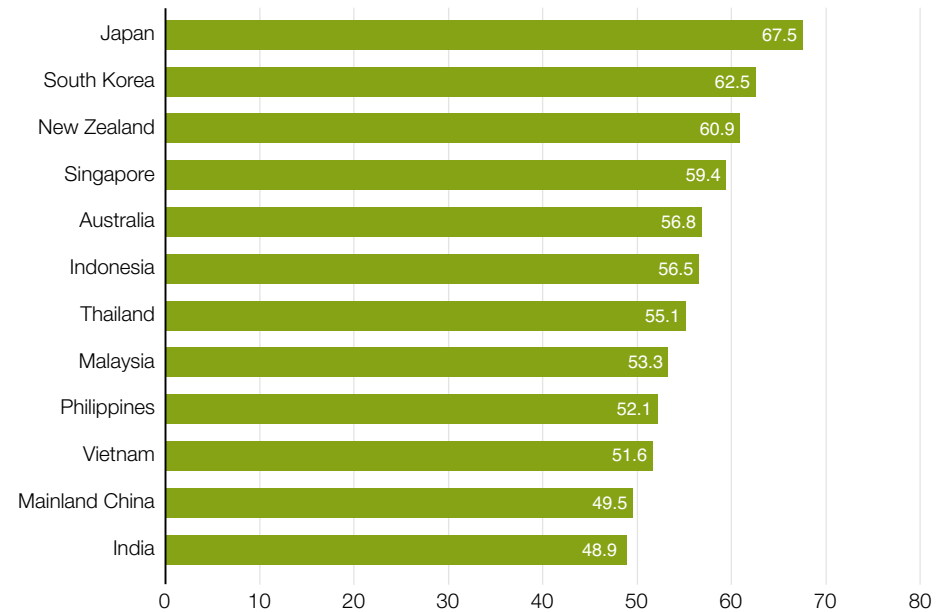
As a Tokyo-based investor said: “You want to layer in another level of cost to be aggressive on ESG, but sometimes it’s just too much to bear economically because you have all these other cost pressures. So I can’t speak for everybody, but that’s something that would recalibrate people’s ESG implementation – maybe they have to put off some things they want to do because they can’t afford it.”

Another by-product of carbon-neutral agendas is a growing trend among some global funds to pursue deals in green energy infrastructure. In part, this is because funds see them as profitable businesses in themselves. But investors are also motivated to marry the output of this infrastructure to the needs of their own and other real estate projects, as demand for energy-efficient buildings rises.

According to a manager at one such fund: “We launched a business in Southeast Asia focused on both utility-scale power (in Vietnam that’s solar and offshore wind) and then also [another] business where we are selling power to end users. We see that as a huge opportunity because all our tenants – including data centres who are huge power users – have net zero requirements, and the only way to get there is through renewable power. So bringing those together is really critical.”

At the same time, however, awareness of ESG (and particularly energy efficiency)

Exhibit 1-15 Transition Performance Index, 2023



Source: CBRE.

Note: The higher the index number, the lower the transition risk.

agendas in Asian markets remains behind the curve compared to markets in the West, and especially in Europe. While sophisticated investors and owners of institutional-grade assets continue to bear the net zero torch, therefore, the level of awareness outside this group can be weak.

According to a Seoul-based net zero consultant: “Even during the good times, the idea of healthy or energy-efficient buildings, when you talk about it behind closed doors, people just don’t know. They’ve heard of it, maybe, and there is a small group of Asian property companies who sing the song and are bona fide interested in driving down their carbon. But a lot of them, 90 percent, I think, don’t find it all that important.”

Data collection, for example, has now become widely embraced as a necessary first step in addressing energy efficiency issues by many portfolio managers. But beyond that, there is often little understanding of what the numbers mean and how they can be used to improve carbon intensity. “Does the CFO and CEO look at that data?,” asked the consultant. “I would say only a very small

percentage do. Down in the basements of these large buildings, they’re not looking at kilowatt-hours times the price of that energy, which equals money; they’re managing peaks so that they don’t burn out fuses. So for investment-grade office buildings or hotels or logistics, I would say less than 10 percent really understand that data and are having CEOs look at it and help drive [energy use] down.”

For this reason, he suggests, the goal of achieving carbon efficiency in the Asia Pacific would be best served – apart from the usual dialogue with well-informed owners and investors at the top end of the market – by a more focused approach to engage the large base of owners who manage the majority of (often older) building stock. In doing so, messaging should be pitched generally on a more back-to-basics level, focusing on incremental improvements and looking to educate how ESG-compliant buildings can attract better-paying tenants, improve asset values in the eyes of global investors, and eliminate risk of stranding.



# Chapter 2: Real Estate Capital Flows

“If banks aren’t willing to extend and pretend, owners might like to delay and pray – but if banks won’t let them, that forces sales and you get price discovery.”

Findings from this year’s *Emerging Trends* investment prospects rankings reveal a surprisingly optimistic outlook given a correspondingly gloomy global background featuring persistently high inflation, a potential global recession, and the most aggressive monetary tightening of modern times. Six cities scored in the “generally good” category (compared with seven last year), three fell into the “generally poor” category (compared with one last year), and sentiment overall registered levels slightly lower than those of the 2023 report, but roughly on a par with surveys in 2021 and 2022.

Exhibit 2-1 City Investment Prospects, 2024

	Generally poor	Fair	Generally good
1 Tokyo			6.62
2 Sydney			6.32
3 Osaka			6.03
4 Singapore			5.95
5 Melbourne			5.79
6 Seoul			5.77
7 New Delhi		4.95	
8 Ho Chi Minh City		4.88	
9 Mumbai		4.87	
10 Bangkok		4.67	
11 Shenzhen		4.64	
12 Shanghai		4.55	
13 Kuala Lumpur		4.53	
14 Auckland		4.52	
15 Bangalore		4.45	
16 Hong Kong		4.38	
17 Manila		4.34	
18 Jakarta		4.29	
19 Taipei		4.25	
20 Beijing	3.87		
21 Guangzhou	3.80		
22 China – second-tier cities	3.12		

Source: *Emerging Trends in Real Estate Asia Pacific 2024* survey.  
 Note: Cities are scored on a nine-point scale.

To a great extent, this benign perspective is probably a reflection of the extent to which Asia Pacific markets have so far

avoided the slow-motion unravelling now underway in European and (especially) US office markets, where utilisation rates remain at barely 50 percent of historical levels, and by some estimates values will decline by 40 to 45 percent of pre-COVID levels.

Beyond that, it also reflects an expectation that Asia Pacific economies will to some extent remain insulated from downturns in the rest of the world and that, while values for regional commercial real estate will eventually reset lower, those levels will not be nearly as low as in markets now plumbing the depths in the West.

Turning to the individual rankings, a sharp dichotomy has surfaced again between the top six cities – which are the same as last year, although not necessarily in the same order – and those in the “fair” category. The appearance of Tokyo and Osaka in first and third places is no surprise given that Japan’s low interest rates make it the only major market (apart from Mainland China), to offer positive carry over the cost of debt.

In addition, Japan has today become a beneficiary of capital that might otherwise have been earmarked for China, while its large and liquid markets have anyway long been seen as a safe harbour in times of economic retrenchment. Finally, the collapse in value of the Japanese yen as a result of the widening gulf between domestic and international interest rates has made Japanese real estate significantly cheaper than in previous years for US-dollar denominated capital, giving many investors reason to see it as a side bet that the yen will eventually revert to the mean.

Still, some investors voiced concerns about Japan, if only because so many foreigners see it as the only Asia Pacific market in which they are willing to invest at all, and because super-compressed

cap rates leave very thin margins for error. Low interest rates “have given people an expectation they will realise a return”, said one investor, “but right now I just feel it’s late in the cycle.”

Exhibit 2-2 Cities Most Likely to See Office Rental Growth in 2024

	2024	2023
1 Singapore	6.24	5.81
2 Sydney	6.09	5.03
3 Seoul	5.98	4.49
4 Tokyo	5.96	5.12
5 Osaka	5.73	4.58
6 Melbourne	5.70	4.58
7 Bangalore	5.58	3.40
8 Mumbai	5.55	3.90
9 Bangkok	5.44	3.91
10 Manila	5.42	3.98
11 New Delhi	5.41	4.16
12 Ho Chi Minh City	5.33	4.94
13 Kuala Lumpur	5.33	3.98
14 Jakarta	5.17	4.40
15 Taipei	5.16	3.90
16 Shenzhen	5.05	4.35
17 Auckland	5.02	3.68
18 Shanghai	4.86	4.55
19 Hong Kong	4.81	4.45
20 Beijing	4.63	4.15
21 Guangzhou	4.52	4.06
22 China – second-tier cities	3.91	3.55

Source: *Emerging Trends in Real Estate Asia Pacific* surveys.  
 Note: Cities are scored on a nine-point scale.

Strong rankings for both Sydney and Melbourne underline continuing interest in Australian assets, despite a slump in transactions for grade A offices, especially from global institutions, who were conspicuous by their absence in the first nine months of the year. The sector has been dragged down by wide bid-ask spreads, low occupancies, and interest rates that – alongside those in Hong Kong – are the highest in the region.

Anecdotally, interviewees reported that in the final quarter of 2023, global funds were again circling core assets in Australian CBDs, albeit still looking for lower than currently advertised prices.

In particular, several interviewees identified Sydney grade A office as a promising trade for 2024, betting on tenants upgrading from poorly located grade B buildings. "Occupiers want better-quality buildings in the highly-connected transportation hub," said one investor, citing the "Migrating to Quality" trend identified in chapter 1.

Of the two remaining top-ranking cities, Singapore remains as popular as ever. That said, owners have remained stubbornly resistant to the notion of cap rate expansion, causing deals for grade A assets to fall away as a result. At the same time, however, high-net-worth buyers have been actively acquiring smaller properties such as shop houses and strata-title assets.

Investors continue to see Singapore as a viable core market given limited supply, booming demand for space, and prospects for rental growth that are among the highest of any Asia Pacific city (see results in exhibit 2-2). With some institutional owners now rumoured to be at least willing to entertain the idea of negotiating higher cap rate deals, there is hope the transaction logjam will be broken in 2024.

Rounding out the top group is Seoul, which has proved something of an enigma in recent years. During the first half of 2023, a bank-sector liquidity crisis ended in a wave of distress sales, despite the city's near zero-vacancy office sector making it one of the tightest in the world. Bidders flocked to buy, making Seoul one of the strongest transactional office markets globally in the second quarter of the year. With supply shortages and rental growth likely to continue for the foreseeable future, Seoul currently embodies exactly the type of inflation-resistant environment investors are currently seeking.

However, although foreign buyers remain interested, Seoul's peculiar dynamics mean it is currently a market driven by cash-rich domestic investors, whose interest in local assets has been amplified as they retreat from global markets following losses incurred in recent years. As one foreign fund manager said: "We looked at Korea, but the market is definitely suffering and is much more challenging because of [high] interest rates and how the banks work. Sometimes, in a similar way to Japan, Korean banks can be very aggressive for very core assets, so we decided to put Korea on hold for the time being."

Apart from this collection of top-ranked cities, prospects elsewhere in the region are less notable, with a couple of exceptions. Chief among them are cities in India, which in recent years have clustered around the bottom of the table as the country worked its way through a traumatic period during the COVID pandemic, as well as a commercial crisis in the non-bank finance sector. Today, however, there is a growing sense of excitement over the potential for India to serve as an alternative industrial base to China, with which it shares synergies in terms of demographics and market depth. With investment activity remaining

Exhibit 2-3 Historical Investment Prospect Rankings

	2024	2023	2022	2021	2020	2019	2018	2017	2016	2015
Tokyo	1	2	1	2	2	4	7	12	1	1
Sydney	2	3	3	3	4	3	1	9	2	4
Osaka	3	4	6	8	8	5	10	15	4	3
Singapore	4	1	2	1	1	2	3	21	11	9
Melbourne	5	6	4	6	5	1	2	16	3	5
Seoul	6	5	5	4	10	9	19	17	7	7
New Delhi	7	13	19	18	15	17	20	13	16	14
Ho Chi Minh City	8	7	8	5	3	7	5	4	5	13
Mumbai	9	12	17	15	12	13	12	2	13	11
Bangkok	10	11	16	14	11	11	16	8	19	16
Shenzhen	11	8	9	9	6	8	6	5	18	19
Shanghai	12	10	7	7	7	6	4	6	9	6
Kuala Lumpur	13	14	22	20	21	22	21	19	21	12
Auckland	14	15	11	13	19	20	9	14	10	15
Bangalore	15	21	20	21	16	16	15	1	12	17
Hong Kong	16	18	14	22	22	14	13	18	15	21
Manila	17	16	21	19	17	19	18	3	8	8
Jakarta	18	9	18	16	18	15	14	7	6	2
Taipei	19	17	13	11	14	21	22	22	17	18
Beijing	20	19	12	12	13	12	11	11	14	10
Guangzhou	21	20	10	10	9	10	8	10	20	20
China – second-tier cities	22	22	15	17	20	18	17	20	22	22

Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

relatively strong, all Indian cities moved up several places from last year's rankings. Going forward, many investors are looking to expand from a traditional focus on office campuses towards industrial and logistics plays.

At the bottom of the table lie a group of cities from China, with a couple more – Shenzhen and Shanghai – marooned in mid-table. These rankings reflect both a near-unanimous aversion among foreign investors towards buying assets in China today (especially in non-first-tier cities, which placed a distant last) as well as an acknowledgement that Mainland markets are too big to ignore, especially with major buying opportunities in prospect as domestic developers are forced to address rapidly deteriorating balance sheets. Multifamily and logistics assets located in China's busiest business areas are therefore still very much on investor watch lists.

## Development Prospect Rankings

As discussed in chapter 1, rising development risk has been a looming issue over the past couple of years due to growing doubts about long-term demand for space in the office and retail sectors. Concerns have only deepened in 2023 as flagging economic indicators suggest the potential for secular declines may be compounded by a concurrent cyclical reversal.

Construction starts have fallen, therefore, and in some cases work on ongoing development projects has stalled. According to a Tokyo-based developer: "I'd say where we've seen yellow caution lights has been on the development side, mainly because of inflation, supply chain issues, and also human resourcing issues. Certainly, for the logistics sector, we've been seeing increases in construction costs of probably 20 percent."

These influences are leading to both higher rents and lower land prices, the developer said, adding: "When we send bids in for corporate factory land, [our brokers] are now telling their clients that times have changed and prices are not

what they used to be, so I think we're going to see some adjustments in land prices, which is something we didn't see even six months ago."

### Exhibit 2-4 City Development Prospects, 2024

	Generally poor	Fair	Generally good
1 Tokyo			6.09
2 Sydney			6.09
3 Singapore			5.89
4 Osaka			5.76
5 Seoul			5.58
6 Melbourne			5.56
7 Ho Chi Minh City			5.12
8 Mumbai			5.01
9 New Delhi			4.97
10 Shanghai			4.77
11 Kuala Lumpur			4.76
12 Bangkok			4.75
13 Shenzhen			4.73
14 Jakarta			4.72
15 Manila			4.63
16 Bangalore			4.54
17 Hong Kong			4.49
18 Auckland			4.43
19 Taipei			4.42
20 Beijing			4.20
21 Guangzhou			4.20
22 China – second-tier cities			3.57

Source: *Emerging Trends in Real Estate Asia Pacific 2024 survey*.

Note: Cities are scored on a nine-point scale.

As a result of dwindling development pipelines, markets with pre-existing shortages of space will probably deliver both good rental growth and better opportunities for build-to-core development. This includes cities such as Seoul (ranked fifth in the development prospects table), which had super-tight office occupancies of some 99 percent in the third quarter of 2023, as well as Singapore (ranked third), which is seeing an influx of new multinational occupiers who are either relocating from Hong Kong or establishing regional headquarters in the city.

In addition, investors are still willing to take development risk in sectors where strong secular demand is driving long-term rental growth. These include, almost by definition, just about every alternative asset class, given that stock does not

currently exist or at least is not completely built out.

Multifamily projects in Japan, therefore, where most established residential assets have long-since been swept up into institutional portfolios, continue to attract development capital. According to one institutional investor with a large multifamily portfolio in Japan: "We feel we know the market reasonably well, so I think we should execute more on the value-add side, because the buying-stabilised-assets and then rolling-through-cap-rate-compression play just isn't there anymore. So [today] it's really about how to build, and then participating in the upside of the development, or taking some leasing risk, because you can still get crazy financing on Japanese multifamily."

Build-to-rent development in Australian cities is also proceeding at pace, although the nature of local markets has raised questions about the long-term viability of build-to-rent strategies. As one fund manager said: "It's really hard to do and is very deal dependent. There's still a mismatch between the returns that people want and what land pricing, construction costs, and current rents can support in your underwrite – that's why there's been so much chat about doing multifamily development in Australia, but less action."

Another noteworthy change in the development prospect rankings is Ho Chi Minh City, which declined this year from second to seventh place. Although interest in Vietnam remains undiminished as global and mainland manufacturers divert capacity away from China to other emerging market locations, a recent government crackdown in the Vietnamese banking and development sectors has led to an acute shortage of liquidity for domestic developers, delaying many ongoing construction projects. Most likely, however, and in line with past experience in Vietnam, this campaign will be temporary, with a return to business as usual expected next year. Demand for industrial capacity is likely to remain strong given the enormous structural undersupply of required infrastructure.

In general, while heightened risk is for now deterring investors from pursuing development projects, the region’s ongoing economic growth and evolving demographic profile mean that long-term demand for new stock is bound to rise. As a result, new development is bound to continue with it, with risk being repriced in the same way as for completed assets.

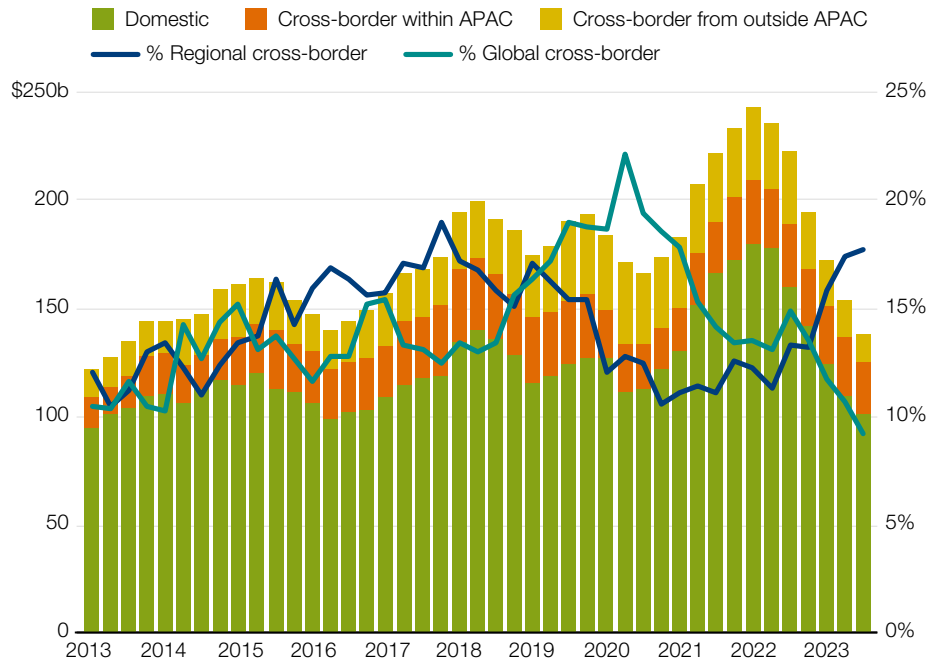
As one fund manager put it: “In the past, people were taking on development because they couldn’t acquire stock in the sector they wanted, so they said ‘if I can’t buy logistics, I may as well build it’, or ‘I can’t buy a good office building, so I’ll forward fund it’. But there wasn’t a huge premium for taking on delivery risk. Today, I think you are getting paid to do that. You have to be aware, though, that there is more risk and therefore more return, so how you quarantine and mitigate those risks will be key.”

### Global Cross-Border Investments Sink

While overall transaction volumes in the Asia Pacific dropped 37 percent year-on-year in the third quarter of 2023 to US\$25.7 billion, there was a striking dichotomy between the portions attributable to cross-border flows. On the one hand, capital originating from other markets within the Asia Pacific remained close to last year’s level on a year-on-year basis, while on the other, capital coming from outside (i.e., from global investors) plunged 64 percent to just US\$12.7 billion – a level approaching historic lows (see exhibit 2-5).

Although one reason for the ongoing strength of intra-Asian flows (of which Singapore accounted for more than half in the third quarter of 2023) is simply that Asian investors remain positive about regional prospects, another reason is surging outbound investment from Japan. In terms of Japanese investments directed to other Asia Pacific markets, flows totalled US\$2.5 billion in the first half of the year, of which more than half was sunk into a couple of large deals in Australia (one office, one residential).

Exhibit 2-5 APAC Investment by Regional Source of Capital, 3Q 2023

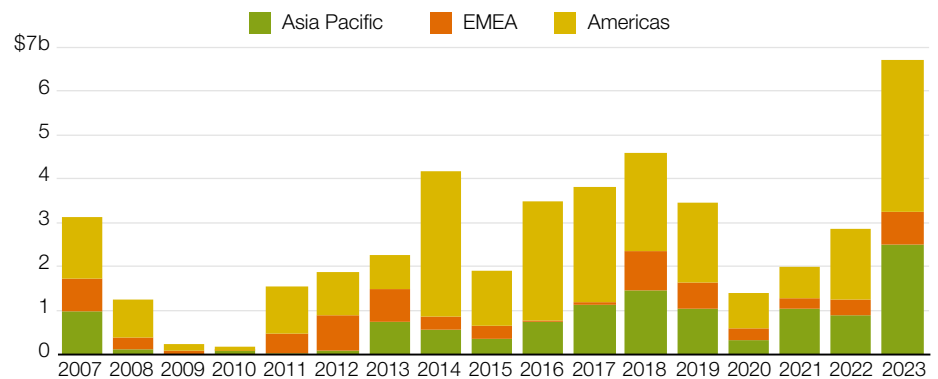


Source: MSCI Real Capital Analytics.

The decision to dispatch more capital abroad in 2023 was obviously an attempt to improve on the slim returns generated domestically as a result of the country’s ultra-low interest rates. Beyond that, however, the real significance of the sudden increase is that it has happened at all. Japan’s vast reserves of institutional capital have long been stuck in unproductive investments such as near-zero-yielding Japanese

Government Bonds. So far, however – and despite much talk – there has been little inclination to send much of this money overseas, where higher returns are available. If this spike in outward flows is an indication, therefore, that the outbound dam is crumbling, there is plenty more where it came from to add to Asia’s already large pile of dry powder investment capital.

Exhibit 2-6 Japan Outbound Capital Flows, 2Q 2023



Source: MSCI Real Capital Analytics.



Ironically, 2023 has been notable not only for capital being dispatched out of Japan, but also for flows moving in the opposite direction. For reasons discussed elsewhere in this report, Japan is currently the only Asia Pacific market (with the arguable exception of India) where foreign investors have been willing to deploy capital in significant volumes. As a result, inbound flows accounted for around one-fourth of Japan's total real estate investment volume in the second quarter of the year, according to JLL, with the logistics and industrial sectors receiving most of this money (see Japan Industrial Deal Volumes chart in "Japan: Key Themes" sidebar).

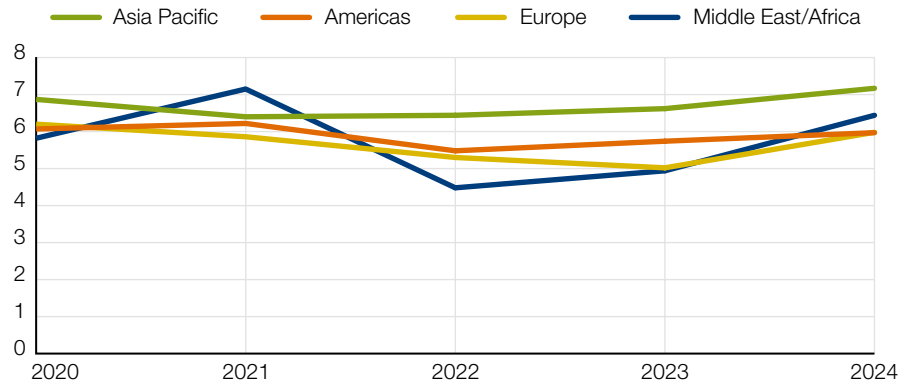
At the same time, though, some investors see the Japanese story as being late in the cycle. As one interviewee said: "Increasingly, we feel that once the US has repriced and the market begins normalising, the positive-carry advantage for Japan will be gone, and the equilibrium might then change. If that happens, then Australia becomes attractive, the US becomes attractive, Europe becomes attractive, and capital might focus on those markets instead."

### Global Capital Holds Back

While flows of capital between different Asian countries have remained robust, the decline in cross-border capital originating from outside the region is striking. This reversal has various elements. To begin with, global investors have a natural inclination to decamp to home jurisdictions in times of economic stress. As one investor said: "From a long-term perspective, the Asia Pacific has reasonable fundamentals that will continue to make it an allocation in global portfolios – it's just that in times of volatility and distress you have to fight the fire today."

In addition, many global institutional investors operate diversified portfolios that have a mandate to maintain a balance between different asset types. With listed markets in the West (particularly bond markets) now generally depressed, many of these investors currently have little if any discretion to deploy more capital in private

Exhibit 2-7 Expected Change in Capital Flows into Asian Markets over the Next Five Years



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

equity assets due to the "denominator effect". According to a fund manager at one such fund: "Usually, the target for real estate is between 8 and 10 percent of the balance sheet, but given the denominator effect, real estate was at one point closer to 12 to 13 percent, which means that globally the trend is now to stabilise and slightly reduce exposure to real estate until the fixed-income bucket becomes bigger."

A number of other factors are also in play. For one, the pool of assets in which institutional funds are willing to invest has shrunk dramatically because tenant demand for former market favourites (i.e., office and retail assets) is now in question. While this structural-decline story may have less resonance in the Asia Pacific, investors watching the downward spiral of these sectors in the West are more inclined to shoot first than to entertain rationalisations as to why Asia may be different.

Another issue is that underwriting the returns required by global funds in these big-ticket items has become difficult due to rising cost of debt. As one institutional fund manager said: "It's hard today to make things stack up, because inevitably if you increase the equity to not have so much debt, then the absolute return on your equity is diluted."

This problem is compounded by reluctance among owners – especially in markets such as Singapore and Hong Kong – to allow cap rates to rise above the

cost of borrowing. Capital values have already fallen, they say, so underwritten values should include prospects for a market rebound. Buyers don't see it that way, though. Said one: "I get it, but we are in a recessionary mode and there's no occupier demand, so how can we guarantee values will grow? It's very difficult to pass that by investment committees."

Another way that global flows have changed relates to geographical allocation within the region. In particular, funds that normally would have placed significant amounts of capital in China are currently no longer willing or able to do so (e.g., because of limited partner (LP) mandates). At the same time, however, that capital still has to go somewhere, which means allocations to either Japan or Australia have increased.

Still, and notwithstanding the current freeze on deployments, the prospects for global investors rebooting regional investment allocations remain strong over the short- to medium-term, simply because economic fundamentals in the Asia Pacific are seen as stronger than in the West. As one Tokyo-based fund manager said: "If you speak to people in the US or even Europe, no one has any hope for the market to recover in the next two to three years. I'm in touch with a lot of Canadian and European pension funds, and when they look at their allocations, they are all looking to the Asia Pacific."

## Fundraising Falls, Dry Powder Rises

The overall lack of buying in Asia Pacific markets since mid-2022 (led in particular by diminishing interest in Chinese assets) gives LPs little incentive to allocate new capital to regional real estate strategies, especially when transactions are slow and levels of dry powder are already high. Fundraising has fallen drastically as a result. According to analysts Preqin, real estate private capital fundraising in the Asia Pacific in the first three quarters of 2023 was down 35 percent year-on-year. Full-year fundraising totals are expected to be the lowest in a decade.

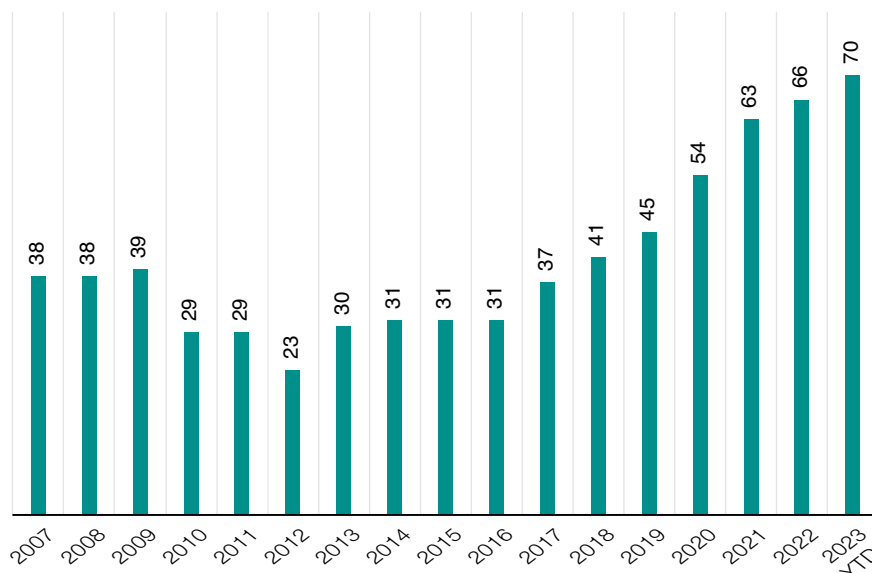
In addition, the majority of capital raised recently has been at the behest of a handful of the biggest funds, leaving slim pickings for others. According to one fund manager: “Raising private capital is near impossible for a second-liner – some funds that have good relationships with Asian capital are doing okay, but it’s very difficult for anyone below [the biggest funds] to find capital.”

Still, some asset classes and/or markets have not been as badly affected. The Australian build-to-rent and logistics markets, for example, have seen significant capital raised, including in particular from Japan. Unsurprisingly too, opportunistic strategies are currently in favour, with almost half of all capital held by Asia Pacific funds dedicated to the asset class in the final quarter of 2023, according to Preqin.

One problem caused by the lack of transactions is that funds are likely to remain in markets longer, thereby stranding some LPs who are seeking access to their capital as a result of denominator-effect portfolio rebalancing.

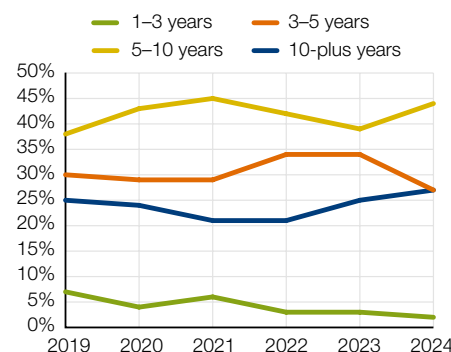
The absence of a mature secondaries market in the region has compounded this issue. A number of managers globally have sought to offer deals by tender to address this issue, often in combination with an opportunity for secondaries buyers to commit new capital to funds. The response has been tepid, however, especially in the Asia

Exhibit 2-8 Asia Pacific Funds Dry Powder, 2007–2023 (USD bn)



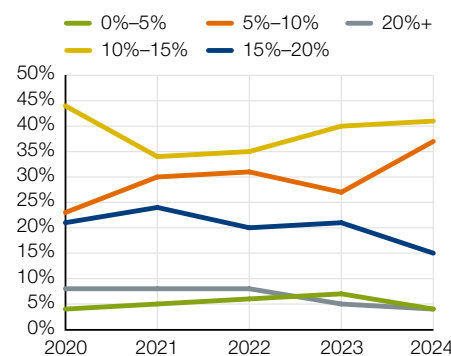
Source: Preqin, JLL, as of September 2023.

Exhibit 2-9 Time Horizon for Investing



Source: Emerging Trends in Real Estate Asia Pacific surveys.

Exhibit 2-10 Investors’ Targeted Returns between Survey and End of 2024



Source: Emerging Trends in Real Estate Asia Pacific surveys.

Pacific, where deal pricing for tenders has often been discounted. LP-led secondaries in the region amounted to just 4 percent of such deals globally in 2022, according to fund placement advisors Campbell Luytens. As one investor said: “Basically, we don’t have a secondary market in this region, so we are stuck.”

## REITs Offer Privatisation Options

As a general rule, real estate investment trust (REIT) prices decline when interest rates rise because higher borrowing costs become a drag on net income, while simultaneously eroding REITs’ ability to buy accretive assets. In addition, as bond yields rise in parallel with interest rates, REIT shares become less attractive given their higher risk profile. Finally, most (though by no means all) REIT assets comprise traditional asset classes such as office and retail properties of the type currently out of favour among investors.

Regional REIT markets have therefore sold off since mid-2022, when interest rates began rising. While still performing better than their US and Europe peers, the S&P High Yield Asia Pacific Select

REITs Index traded about 6.4 percent down year-on-year as of early November (see exhibit 2-11). REITs continue to trade at a significant discount to net asset value (NAV) in all markets except Japan, where government-sponsored buying as part of Japan's quantitative easing programme has pushed REIT share prices higher.

The diverging paths of asset values in public and private markets have various consequences. First, they have led to a line of thought that privately owned assets (which have yet to reprice significantly) should be revalued using REIT NAVs as benchmarks. While convenient, this idea is unpopular among asset owners given that publicly listed assets (whether REITs or regional developers) tend anyway to trade below the values of the same assets bought and sold privately. In addition, public markets will often over-react to the downside during bear markets and may therefore not in their own right be an accurate gauge of value.

Second, REITs are increasingly being eyed as privatisation targets. With REITs in Singapore seen as overly subject to government control and those in Hong Kong having generally low asset quality, the markets most suitable for such a strategy are seen as Japan (for REITs that lack a local sponsor) and Australia.

According to a manager at a large institutional fund in Sydney: "We think it makes sense if REITs without a funds management arm are trading at big discounts to NTA [net tangible assets]. It's then a question, first, of whether you believe the NTA or not. And then, do you have access to the capital to actually do the privatisation? Because there was a lot of consolidation of REITs just after the global financial crisis, and there are just not many pure-play REITs left that are small enough to privatise with two or three big investors in a syndicate."

In addition, in the words of another interviewee: "In public market trading, [Australian REITs] might be at a 40 percent discount to NAV. But if you sell to the private market at only a 15 to 20 percent discount, you get a big gain on the public vehicle. So the REITs want to

Exhibit 2-11 **Asia Pacific REITs Five-Year Index (US dollars)**



Source: S&P Dow Jones Indices.

sell to raise money, while investors think a 20 percent discount is good enough. And that's when the markets start to move – it's a win-win situation, but we haven't seen enough of it just yet."

### Bank Lending Slows, Terms Tighten

The most fundamental change seen in global real estate markets in over a decade has been the series of quick-fire interest rate hikes – the fastest ever – introduced by the US Federal Reserve since mid-2022. As discussed in chapter 1, the higher cost of capital in markets across the Asia Pacific (Japan and China excepted) has forced investors to abandon the thesis on which much commercial real estate investing has been based since 2009: use cheap leverage to buy core assets, wait for cap rates to compress, then exit to another fund a few years down the line.

Today, bank debt is no longer cheap and easy, and in some cases is not available at all. International banks, in particular, are wary of extending new loans, and are now often declining to renew existing

deals. At the same time, borrowing for office investments is especially at risk as banks look to reduce their exposure and intensify their due diligence.

According to a Singapore-based fund manager: "It varies market by market, but there is definitely more attention to detail on the underwriting side, and a consolidation in terms of borrowers. This means it [lending] isn't available to all and sundry, which is a big difference from a year ago, and the propensity to issue loans is definitely not the same. Pricing is different in different markets – so in the US, it's up 500 to 600 basis points, while in Singapore/India/Japan it's up 50 to 100 basis points. But also, the counterparties that are able to execute at that pricing, I think, have shrunk dramatically."

Interviewees identified Hong Kong, Mainland China, and South Korea as markets where banks have become noticeably more reluctant to lend, although that reluctance may be greater for certain asset classes (mass market residential in China, logistics assets in Korea, or multifamily development in Australia, for example).

Where debt is available, cost of borrowing can vary significantly by market. Lowest available bank borrowing costs stood in a range of between 0.8 and 6.7 percent (see exhibit 1-7) as of November 2023. Other lending terms have also been tightened, with LTVs dropping by an average of about 10 percentage points, and interest coverage ratios (ICRs) stricter in many cases.

Japan and China are major exceptions to the higher interest rate trend. Japan has opted to retain its long-term zero interest rate policy, introduced as a form of fiscal stimulus in 1999, and despite the rapid rise in rates globally, lending terms from Japanese banks have tightened only very slightly, according to on-the-ground interviewees. As of early November 2023, the Bank of Japan (BOJ) has proposed it would again allow interest rates to float, although given the implied increase in interest expense on vast amounts of government debt issued over the past 10 years, many analysts believe the BOJ will be unable to allow rates to rise significantly.

China, meanwhile, has steadily reduced interest rates in 2023 as it addresses structural weakness in its economy. For real estate investors, this should again be an incentive to invest, especially given widespread distress throughout the developer sector. However, both geo-political and macro-economic headwinds continue to deter most foreign investors for now.

Although interest rates in many Asia Pacific markets have risen quickly, cap rates have been slow to follow. In Hong Kong, for example, “cost of debt now is four times what it was a year ago,” said one fund manager, “and then your margin is 1.5 to 2 percent on top of that, so your debt could be almost 7 percent. But you can’t buy anything at that level in Hong Kong – cap rates are still somewhere between 3 and 4 percent.”

This lofty differential between yields and interest rates is not only a deterrent for new investors, but also creates problems for owners of recently purchased properties. With rents falling as vacancies

rise, growing numbers of owners are almost certainly already in negative equity (in real terms, at least) as well as in breach of ICRs. The test, however, as one investor pointed out, will come as current loans expire: “As this wall of refinancing comes through, the expectation, especially in the office market, is that valuations will drop and they’re going to need to recap[italise] their assets.” How many owners will have the cash or the inclination to do so, however, remains to be seen.

While there have so far been a handful of distress sales in Hong Kong (and even more in China), markets have been slow to accept the new reality, presumably because banks have not been anxious to enforce defaults. That situation may not last, however, in a higher-for-longer interest rate scenario, if central banks decide that sinking real-world valuations pose a systemic risk to banking systems. Other Asia Pacific cities with wide spreads between cap rates and cost of debt (and which therefore pose a potential risk to bank balance sheets) are Melbourne, Sydney, Singapore, and Seoul, although the latter two enjoy vibrant occupier markets that should mitigate risk significantly.

### Private Credit Steps Up

One result of newly tightened bank lending regimes is that the market for real estate debt has widened to include significant numbers of non-bank players. These include cash-rich institutions such as pension funds and insurance companies, or (increasingly) pure-play private equity funds. Although Asia has always had a small market for non-bank debt, until now the vast majority of demand had been met by a regional banking system historically awash in capital made available to borrowers at rates private-sector lenders could not match.

Today, however, the landscape has changed, marking what may be a fundamental shift towards creation of a space for non-bank debt along the lines of the more mature private credit markets in the United States and Europe.

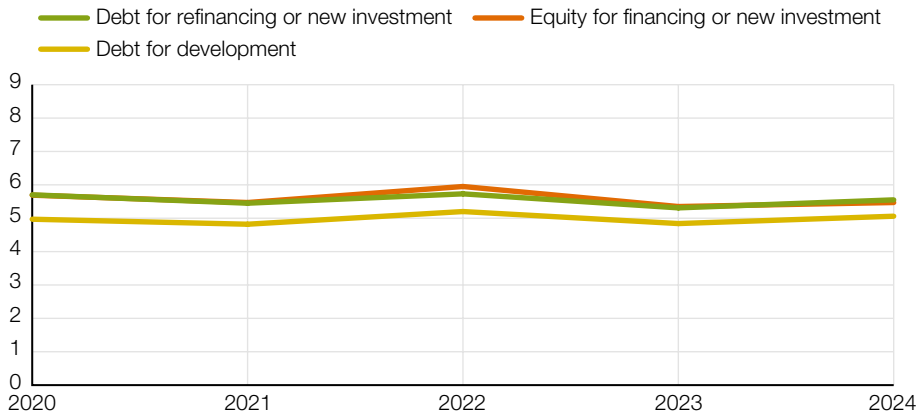
For private credit lenders, this nascent market for Asia Pacific debt coincides with an increasingly risky environment for investing using equity. As a result, more than a few private equity funds have been willing to sell all or part of their hard-asset portfolios to raise capital for newly minted debt strategies as they pivot to a more defensive posture.

According to a manager at a Singaporean private equity fund: “Base rates are now up in most markets, spreads have gone up in most markets, and there’s also volatility, so investors are saying: ‘If I have to deploy capital, then why not put it into a credit instrument where I have 40 to 45 percent of first-loss positions ahead of me if I’m a senior secured lender?’ And the other interesting dynamic is that, generally, credit is a shorter duration than equity, so it’s actually a perfect way to deploy capital in a volatile time not knowing when it will end. If I’m looking for a development loan, then it’s for 24 months, and for a stabilised loan maybe three to five years, but it’s definitely shorter than a typical equity investment and gives me optionality once this period of volatility ends.”

Another advantage of the creation of a true regional market for non-bank lending is that, while it may be more expensive, private debt is also in general more flexible, with terms that may be more creative, more “covenant-lite”, or more favourable to borrowers. In addition, it offers potential – in particular for debt extended by insurance companies – to lock in longer, five - to 10-year, fixed-rate tenures that would not otherwise be available, thereby creating opportunities to hedge long-term interest rate risk in markets like Japan, where rates are still well below global norms.

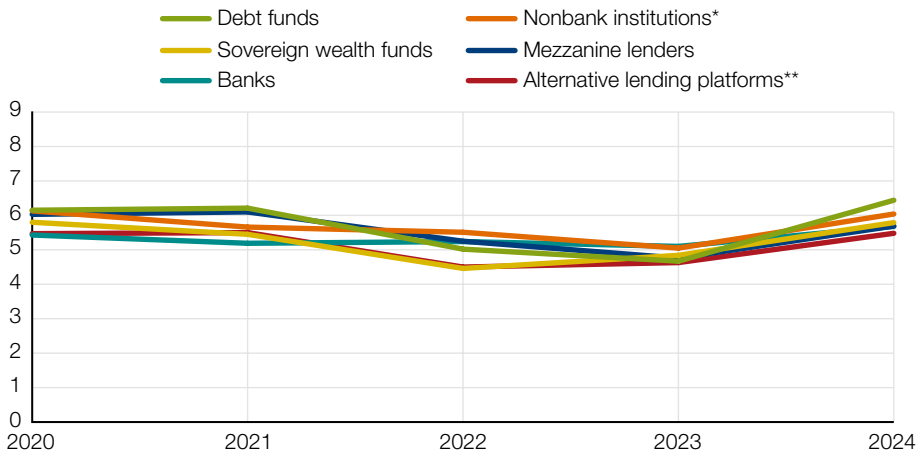
For now, demand for non-bank debt tends to be clustered in specific geographies, asset classes, or situations. For example, according to one interviewee, “Lenders in Asia are all focused on their watch lists, and the main place they are looking to reduce exposure is office, so that’s where you might see [private credit] deals. Especially now that we’re a year into this tightening cycle, even smaller lenders are pushing borrowers to refinance, which is causing demand for more expensive

Exhibit 2-12 **Expected Change in Availability of Debt and Equity Finance**



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

Exhibit 2-13 **Availability of Debt by Type of Lender**



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

\* Insurers or pension funds. \*\* Examples include peer-to-peer lending and crowdfunding.

capital in a refinance.” This “funding gap” caused by bank reluctance to provide the entire amounts needed by borrowers to refinance any given asset has been estimated by CBRE to amount to US\$5.8 billion out of a total of US\$177 billion in outstanding senior commercial real estate debt in the region. The shortfall will presumably need to be financed – if at all – via some form of private credit deal.

Beyond that, significant numbers of private equity investors may now be unable to persuade banks to fully finance anticipated levels of leverage underwritten in any given deal, particularly, according to some interviewees, for value-add investments. As a result, private equity

players may be able to step up to provide the necessary loan at a premium to bank debt.

A number of other private credit opportunities were also identified by interviewees:

- In Australia, which has been a growing market for non-bank finance for years as commercial banks slow lending in response to regulatory restrictions, opportunities exist to lend to developers, in particular in multifamily projects, on a senior secured basis. Otherwise, owners of stabilised performing assets may be looking for debt to

upgrade their properties on terms that may be somewhat “off the fairway from where commercial banks will lend”.

- In China, although interest rates are now falling, foreign banks are often opting out of the market altogether, while domestic banks may be unwilling to participate in loan extensions. This is “creating opportunities for investment bank-type capital, or maybe a mezz[anine] piece, or preferred equity, or non-bank stretch senior”. Demand tends to come from foreign investors unable to secure all their needs from domestic banks due to generally lower LTVs.
- In Hong Kong, there is significant distress at the developer level, but also a deep well of high-quality assets that might be collateralised, creating scope to recapitalise across developer portfolios.
- South Korea and Singapore were also identified as potential markets for private credit lending on an opportunistic basis.

Still, while many private equity funds are looking to enter private credit plays opportunistically, relatively few see them as part of the long-term structural evolution of a new lending market. The opportunity may prove more appealing (at scale, anyway) to the stable of institutional investors around the Asia Pacific already in search of suitable avenues to invest large stockpiles of capital, and for whom fixed-income investments that offer stable interest and principal repayments dovetail well with their preference for highly predictable income streams.

According to one fund manager: “The truly performing credit business is opening now. There are a couple of parties that have been in Asia for a long time, doing total return, sometimes lending, sometimes investing. But I think you’ll find in the next two to three years, true lending platforms, performing credit platforms, will be coming up.”



# Chapter 3: Property Type Outlook

“This was the future – we’re now here and it’s not so bad.”

If low cost of debt was the primary factor shaping regional real estate investment strategies over the past 14 years, so today’s higher interest rates are now again helping shape both the flow of capital and the way real estate is likely to be used going forward.

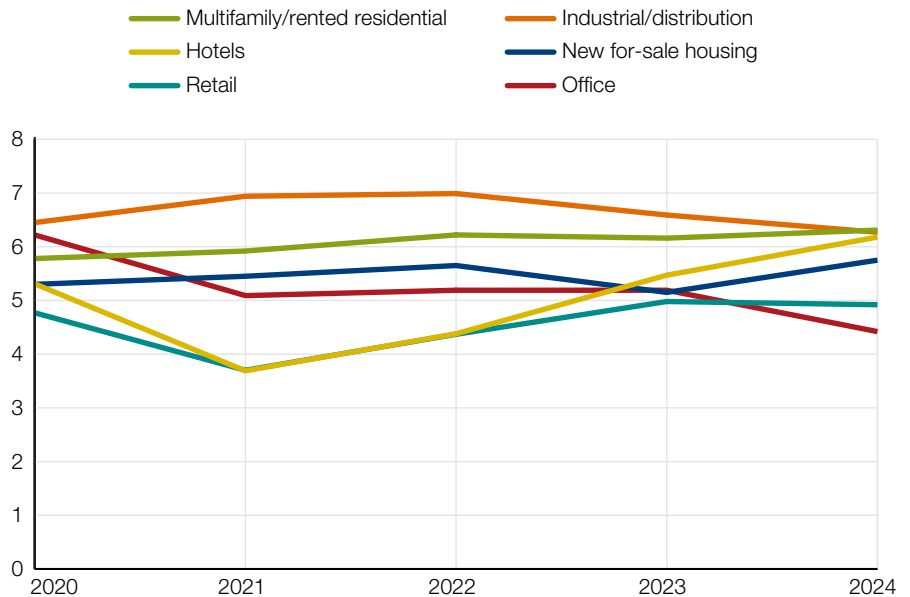
While this implies, to a certain extent, a changing of the guard, it does not mean that office and retail assets – both staples of the old regime – are less important, despite the fact that investors are currently less inclined to buy them. Nonetheless, even if their economic and social roles will endure, the value propositions of these traditional sectors are being redefined.

What this means, firstly, is that their financial values are being re-assessed by reference to their ability to generate the new normal in risk-adjusted returns – a process by now well advanced despite the stagnancy of today’s markets. In addition, it means that investors will seek to squeeze value from assets by identifying new ways to make them more relevant to users – a process that until now had been forestalled because there was little incentive to deviate from established formulas that had delivered good returns.

At the same time, and serving as a catalyst to this value-squeezing exercise, new demand drivers have emerged that are also contributing to the reshaping of use cases for both asset classes. Office owners therefore need to improve their offerings to provide incentives for employees to return to the workplace. Retail operators, meanwhile, need to provide similar incentives to consumers who will otherwise continue to migrate in the direction of internet shopping.

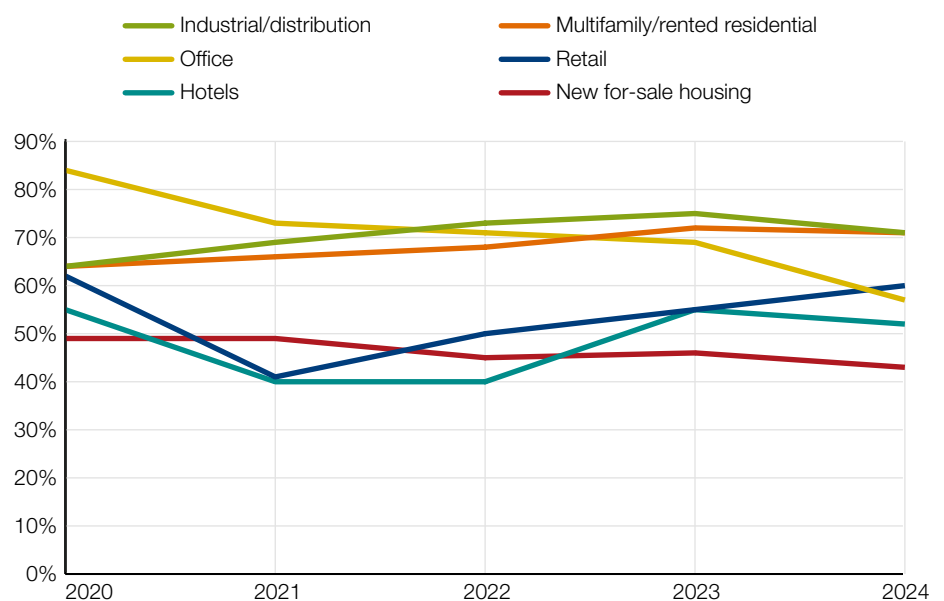
The cathartic events currently taking place in the Western markets, therefore, as huge volumes of office and retail space disappear from central business

Exhibit 3-1 **Prospects for Commercial Property Types**



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

Exhibit 3-2 **Sectors in Which Investors Are Active or Plan to Be Active**



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

districts (CBDs), is one of creative destruction, the results of which will at least to some extent be absorbed by Asia Pacific markets even if they are for now being viewed from afar.

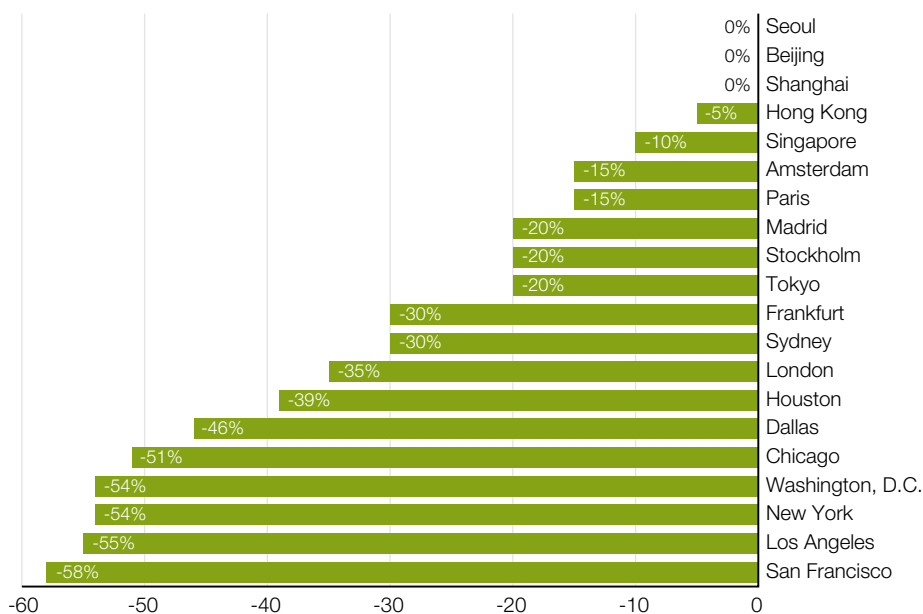
An additional by-product of the rapid rise in interest rates, as discussed in chapter 1, is that investors are turning increasingly to alternative asset classes. These include largely niche themes such as multifamily, data centres, and senior housing. In addition, logistics, while today hardly an alternative after years of headlong growth, continues to appeal, despite cap rates that remain stubbornly compressed. And finally, hotels, long the most prominent victim of COVID lockdowns, are making a comeback, as tourism rebounds in a wave of revenge spending. All these areas can be expected to be the focus of greater investor attention as underwriting formulas are redrawn to generate the higher returns needed in today's higher interest rate environment.

### Office

While pandemic-inspired work-from-home mandates are now firmly in the rear-view mirror, office markets in the West continue to suffer their own version of long COVID, as hybrid working practices saddle major cities with huge amounts of surplus office space. With rising interest rates also affecting values, the consequent downturn in the office sector, formerly the biggest and most active of any real estate asset class, has been dramatic.

As detailed in chapter 1, valuations in Western markets have declined around 30 percent year on year as of the first half of 2023. Although losses have been unevenly distributed, the biggest impact has often been felt in some of the biggest markets, such as San Francisco. What's more, with prospects for a full-scale return to office-based working in the West rapidly receding, much of this space will ultimately have to be repurposed, raising profound questions, not simply in terms of economics, but also as to how redeveloped space can be put to more productive use in what are some of the busiest and most densely populated neighbourhoods of major urban centres.

Exhibit 3-3 **Global Office Re-entry Rates, May 2023**



Source: JLL (Change in office entry compared to pre-pandemic baseline).

An understanding of the decline of commercial real estate in Western markets is illuminating in an Asia Pacific context because of differing on-the-ground conditions that are likely to generate different outcomes than have been seen in the West. Most important, the hollowing out of office markets in North America and Europe is unlikely to be repeated in the Asia Pacific because employees in general are less entrenched in work-from-home regimes.

Office re-entry rates vary significantly across the region, but range from 70 to 100 percent according to a JLL mid-2023 study – a statistic that compares favourably to equivalent rates in Europe (65 to 85 percent), and North America (45 to 65 percent) (see exhibit 3-3). Notably, office re-entries in cities such as Seoul and Shanghai are already back to pre-pandemic levels.

At the other end of the spectrum, the preference for working from home remains strong in Australia. This may reflect both Australia's more workspace-friendly homes as well as a cultural mindset that tends to be less compliant with employer directives.

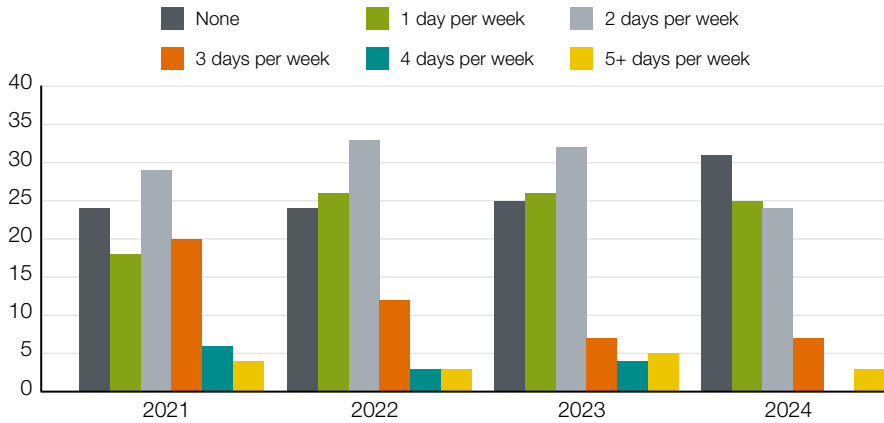
The gradual return of historical working norms in the Asia Pacific seems to be supported by survey responses, which show the number of days spent working from home, for example, declining significantly this year (see exhibit 3-4). In addition, the percentage of businesses opting to embrace hybrid working practices has also declined sharply (see exhibit 3-5).

Still, while the blow to regional office occupancy rates has therefore been softened, office assets have not been immune to the ongoing global reset. This is firstly because they have become tainted by association, with investors avoiding offices "like an allergy" as they take their cue from collapsing values in the West. Another reason is that asking prices have yet to adjust to account for the impact of higher interest rates (although there are recent signs of movement in Australia and China). As a result, transaction volumes were down 50 percent year-on-year in the first three quarters of 2023, by far the biggest decline in any core sector, according to MSCI.

In addition, fundamentals remain soft on a number of fronts. While the work-from-

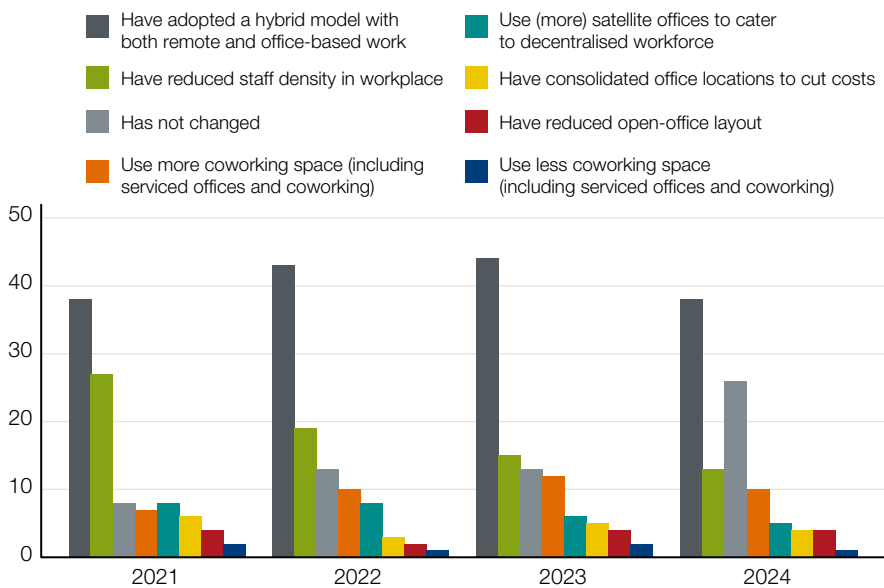


Exhibit 3-4 Average Days per Week Spent Working from Home



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

Exhibit 3-5 How has your organisation's workplace model changed as a result of COVID-19?



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

home trend may be weakening in Asia, the attrition on occupancy rates is still significant, with utilisation currently an average 10 percent below pre-pandemic levels. When combined with lower demand caused by weaker economies, as well as significant oversupply in some cities (in particular Shanghai and Tokyo), the drop in demand has boosted Asia Pacific vacancies to a record 18.7 percent in mid-2023, according to CBRE figures.

High vacancies are noteworthy not only because they serve to compound concerns over structural demand, but also because of the way they have accumulated mainly at the lower end of the market. This is happening in large part because hybrid-working policies allow businesses to accommodate the same number of employees within a smaller floor space and then use the savings generated to upgrade to better-

quality buildings. This phenomenon, which has been the catalyst for the "Migrating to Quality" theme discussed in chapter 1, is creating what is in effect a two-tier market.

One consequence is that the outlook for offices as a whole is not as uniformly gloomy as occupancy and utilisation statistics suggest. As a fund manager in Hong Kong said: "Office gets a lot of negative headlines in the US, but in Asia things are very different given how people work and commute, as well as their overall lifestyles. So I think people are being overcautious about taking anything office-related to global investment committees just because there's so much negativity. It's become a dirty word in the same way that retail was several years ago."

With office deals stagnating and a pipeline of for-sale assets building up, some contrarian investors are considering investing in CBD offices in cities such as Sydney that feature modern, in-demand, facilities, high occupancy, and good prospects for rental growth. In doing so, their expectations are to find a middle ground on valuations, while also avoiding the cut-throat competition such assets have historically drawn.

### Repurposing the CBD

Otherwise, the prospects at the lower end of the market, where many buildings are emptying out, seem bleak, raising the question of what to do with an upcoming glut of underused office space. Although some investors noted the possibility of value-add upgrades for the right type of grade B buildings, these are likely to be the exception rather than the rule. As one Sydney-based fund manager observed: "It goes back to flight to quality – you don't want to buy grade B assets or peripheral locations because the rental gap between the highly-rated and lower-rated assets will widen, and therefore the valuation gap will also widen."

Apart from value-add upgrades, buildings can in principle also be repurposed. This applies particularly to

residential conversion – a pursuit that has been explored extensively in the United States. Chronic housing shortages in Asia Pacific cities, as well as savings in embodied carbon make this an appealing option on its face. In addition, the high proportion of modern buildings in Asia Pacific cities (see exhibit 3-6) seems to favour repurposing strategies given that by nature newer buildings tend to be better suited for conversions.

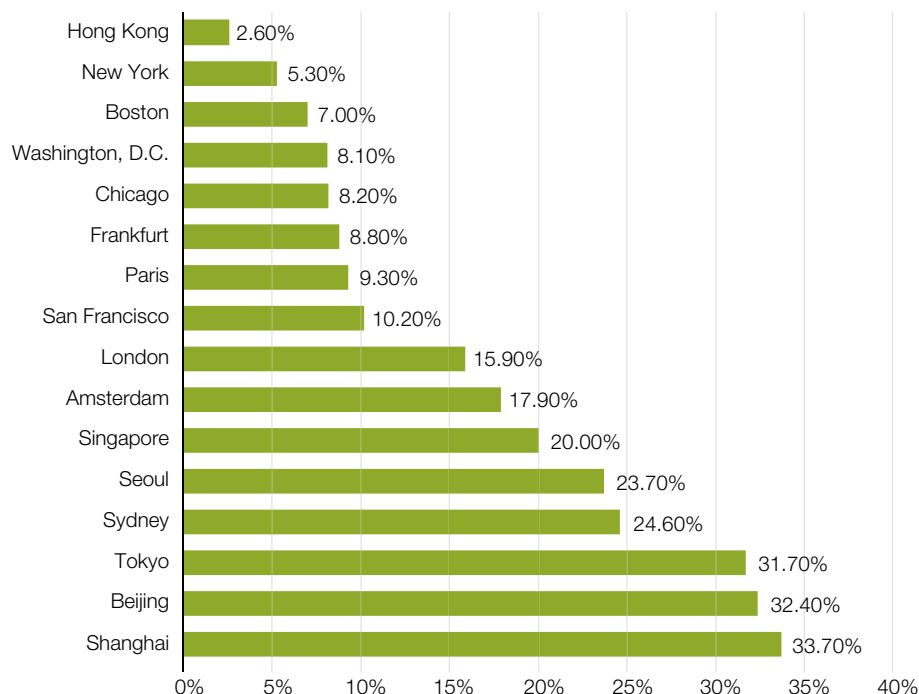
In practice, though, there are limitations to what can be achieved. Experience in the United States has shown that high costs, onerous asset maintenance obligations, inadequate plumbing, and inappropriate floor-plate sizes, among other things, leave demolition the only realistic option in most cases.

The other side of the repurposing coin is how the process should be applied to entire CBD areas (or parts of them) as the emphasis shifts away from high-density business use and in the direction of different formats that offer better social outcomes and liveability.

Asian cities, in particular, have a long way to go in this regard, although regional governments are slowly moving to create catalysts for change. Business improvement districts (BIDs), for example, which evolved in North America in the 1970s, function as collectives in which neighbourhood businesses collaborate to improve their local environments. They typically act to fund services that may be inadequately performed by governments, such as cleaning streets, improving local venues, building pedestrian and streetscape enhancements, and marketing.

The first Asian BIDs have now been established in Singapore, while several others have been set up in Australia since establishment of a pilot BID in Sydney in 2021. Similar conceptual approaches are embodied in other frameworks that have slightly different mandates, such as Sydney's Office of the 24-Hour Economy Commissioner, which focuses among other things on fostering the night-time economy.

Exhibit 3-6 **Proportion of Global Office Stock Built After 2015**



Source: JLL research, May 2023.

### **Perfect Workspaces Remain Elusive**

As owners and occupiers focus on asset management, both to shore up investment values and increase the appeal of assets to prospective tenants and employees, the spotlight has fallen on specific issues. The most basic of these is how to configure the modern workspace to suit hybrid workstyles or evolving employee preferences. Finding the right formula, however, has proved elusive, with employers often rotating through a succession of different options as experimental adaptations either succeed or fail.

In a series of annual surveys conducted by architects Gensler, for example, employees in 10 different countries were asked to identify the most important reasons for working in an office rather than at home. In the first survey, completed soon after the pandemic began, employees specified in-person collaboration with colleagues as more

important than the need for traditional focus-type work, prompting many companies to replace existing desk-oriented space with open, collaborative facilities. This type of elective-based research can be quite unreliable, however, and as the popularity of the new spaces faded – with many “being used at maybe half capacity” – respondents reinstated their preference for focus-type work when asked the same question in 2023, at which point collaborative spaces were restored to the original desk-oriented configurations.

Nor is this experience unusual: several interviewees recounted similar experiences in relation to other innovative changes to workplace design or practices. The unavoidable conclusion is that workspace upgrades are a fickle exercise. Despite the willingness of occupiers and landlords to devote significant resources to identifying employee-friendly formulas, the perfect workplace remains both a moving target and a work in progress.

Other important aspects of workplace improvements involve employee wellness, which has emerged as an important issue for young, gen Z employees who prioritise both physical and psychological wellbeing. Whether this is a consequence of pandemic-related experiences is hard to say, but it is often expressed with an adamancy that surprises an older generation of management and is therefore easy to underestimate. Touchless access, exercise regimes, end-of-trip facilities, and access to outdoor spaces are all options that have been prioritised in wellness-oriented fit-outs.

A related theme is sustainability, and in particular carbon efficiency. This will come as little surprise to owners of investment-grade assets, given it is now a standard element in deal underwriting and is increasingly recognised as a potential long-term threat to asset values. Nonetheless, and as outlined in chapter 1, sustainability issues in the

Asia Pacific are not always as high profile as they are in the West, a problem that is compounded by the intricacy of regulatory agendas, confusing terminology, and often labyrinthine implementation frameworks. While some jurisdictions, such as Australia, Singapore, and (increasingly) Japan are in many ways global leaders, awareness in other markets can be skin deep among asset managers who lack exposure to international practices.

This shortcoming is likely to change over time, however, as both tenants and employees increasingly prioritise sustainability. Rents and values for buildings that fall short of rising standards are increasingly likely to be discounted by the market, while shifting regulatory requirements may soon compel upgrades anyway. As an investor in Tokyo commented: “It will happen more because so many institutions are requiring ESG [environmental, social, and governance] either as a tenant or as an investor, particularly in relation to offices. So if you

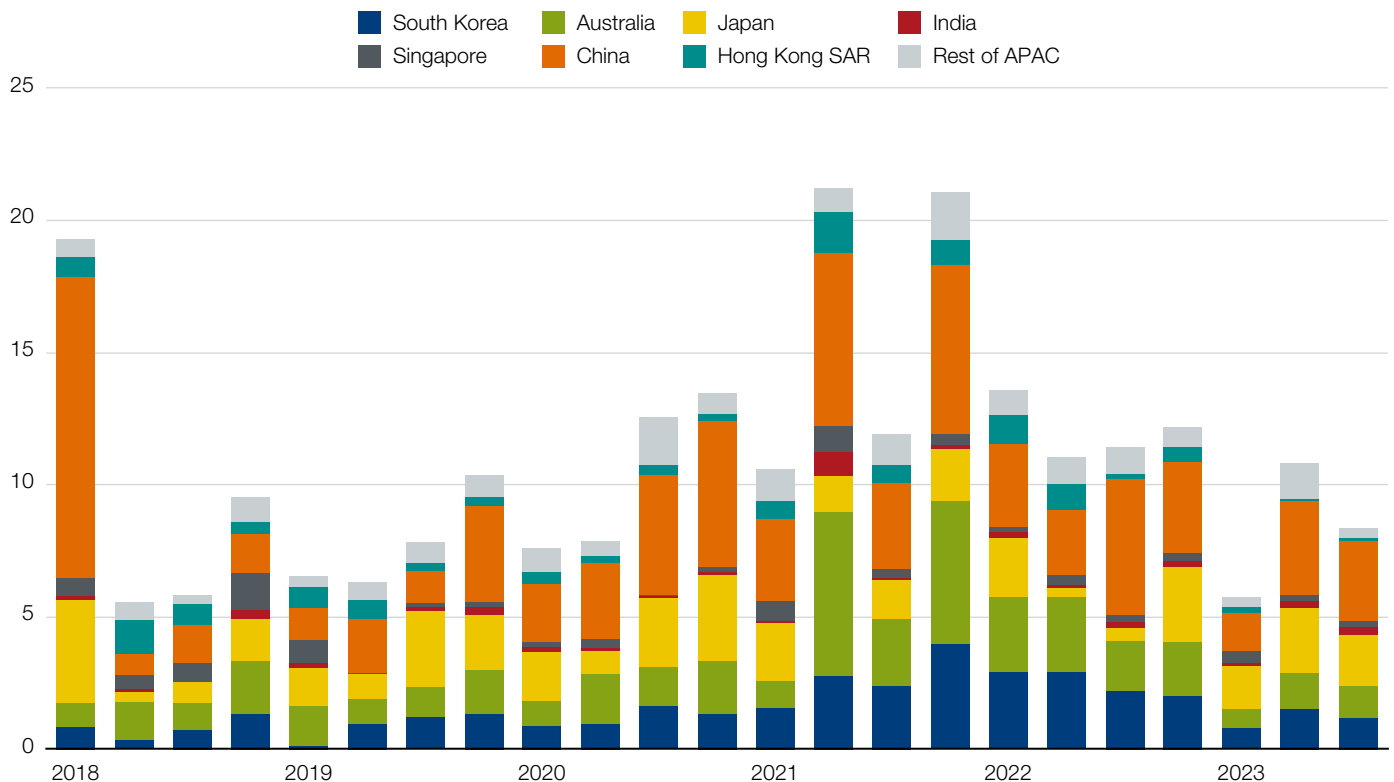
can't provide that, you end up with an asset that's not going to be traded or leased.”

## Logistics

With capital in 2023 migrating away from the historically dominant office and retail sectors, some of the slack has been absorbed by the industrial and logistics sector (including data centres). Asia Pacific transactions amounted to US\$24.9 billion in first three quarters of 2023, and although this was 31 percent down on the year, the sector ranks as the second largest in the Asia Pacific, compared to office deals of US\$31.8 billion over the same time frame, according to MSCI.

This pivot towards logistics assets has been especially strong among global investors, whose office and retail purchases as a share of all Asia Pacific real estate investment fell to 38 percent and 10 percent, respectively, in the year

Exhibit 3-7 Asia Pacific Industrial Deal Volume across Markets, 3Q 2023



Source: MSCI Real Capital Analytics.

to October 2023 – a huge decline from equivalent figures of 60 percent and 24 percent in 2013 (see exhibit 3-8). Most of that gap has been filled by industrial and logistics assets, which have risen from a paltry 5 percent of the total in 2013 to 30 percent today.

Investors have continued to direct capital into logistics properties because the structural undersupply of modern facilities in the region is so profound, as demand grows exponentially due to booming internet retail sales (many of them fulfilled via newly built last-mile facilities), as well as ever-growing requirements for just-in-time delivery from manufacturers.

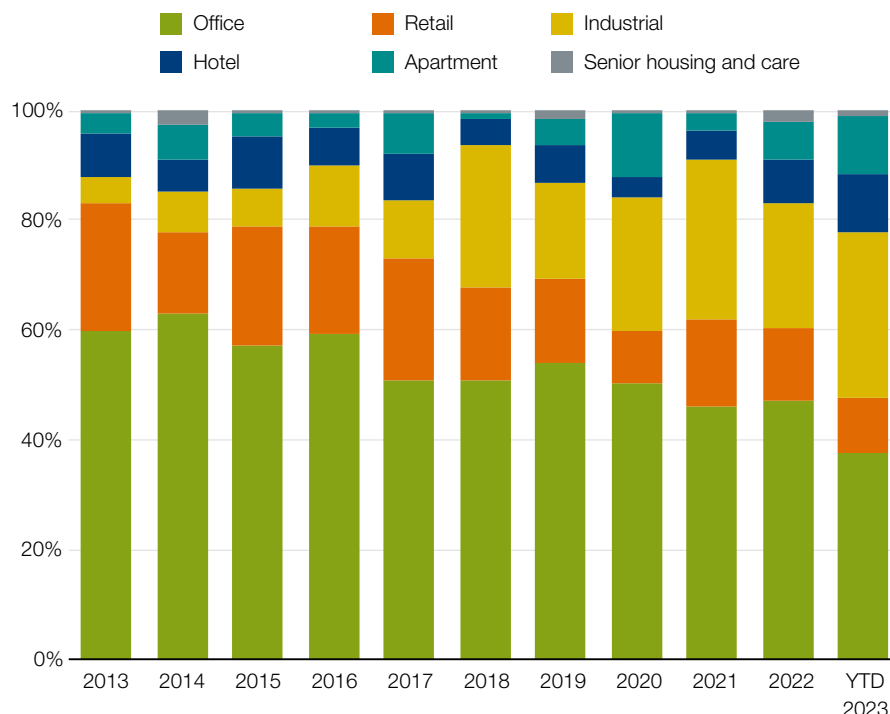
One measure of the level of demand growth for new high-tech distribution centres is that, over the last five years, investment in newly developed industrial facilities has far outstripped equivalent spending on stabilised assets. According to a study by MSCI, construction of some US\$12.9 billion in new properties commenced in Japan during 2022, compared to just US\$5.1 billion in acquisitions of completed assets. For Australia, meanwhile, those figures were US\$4.9 billion and US\$2.6 billion, respectively.

That said, the sharp drop in new construction starts seen in 2023 may be a sign that the structural undersupply story is fading, an idea that is gaining increasing traction among investors, if only because super-high growth rates in both new construction and rents seem intuitively unsustainable.

At the same time, owners and buyers will say that statistics suggest otherwise. With the proportion of modern facilities in all of the big regional industrial and logistics markets still representing only a fraction of existing stock, outsized growth in new supply appears to be a sustainable trend that falls well within the trajectory of long-term demand.

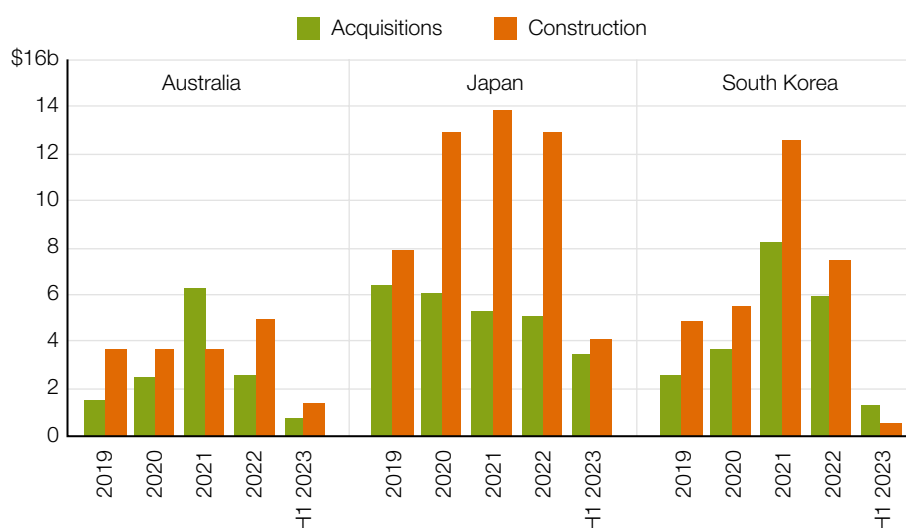
While this may be correct, the demand surge is beginning to taper as internet sales growth falls away post-COVID. In addition, the quality of new stock is so much better than the old – with higher

Exhibit 3-8 **Asia Pacific Institutional Allocations by Sector**



Source: MSCI Real Capital Analytics.

Exhibit 3-9 **Asia Pacific Logistics Construction and Acquisition Volumes**



Source: MSCI Real Capital Analytics.

ceilings, more automation, and heavier floor loading – that occupiers can today move far more product from the same-sized facility than they could in the past. To that extent, projections of demand for new space may be overestimated. The stickiness of vacancies in some Asia Pacific sub-markets during 2023 supports the thesis that demand is moderating.

As one interviewee commented: “They just won’t need the additional space, and if they do, not nearly as much. And it may anyway be more on the fulfilment side, because the infrastructure there is not as good – they may choose to have a variety of different facilities, but in reality it will consist of a big district hub and a couple of fulfilment centres so they can meet their market.”

In Australia, cap rates for industrial and logistics assets had been compressed to as low as 3.5 percent just before base rates began to rise in mid-2022, but since then owners have been reluctant to allow them to increase in line with the cost of bank debt (which stood at about 6.3 percent as of the start of November 2023). The justification usually offered is that shortages of stock are so severe that rents are growing as much as 20 percent annually, thereby increasing capital values and allowing facilities to grow into their valuations. Many owners are opting simply to hold assets and wait for big rental increases once current leases expire, rather than sell at what they see as a discount. As a result, a large bid-ask spread has appeared.

Whether that argument is valid has been the subject of much debate among investors. “I just don’t see the rental growth will be there,” said one logistics industry consultant and former fund manager. “You can develop [new warehouses] and get them leased up, but you know the rent is artificially low because there are so many incentives to get those end users to occupy. And you can’t price the rental because it’s very difficult to get comparables to see what it’s going to be like over the course of time, so you have to have something built into the leases as a step-up to make it attractive for institutional capital.”

The problem, then, is not simply effective rent subsidies, but also built-in rent escalations (of perhaps 2.5 percent) that rarely reflect actual rates of inflation, let alone rental growth. The big occupiers, continued the consultant, “wield so much value in the covenant of their brand, that if they can take a big amount of space, these developers will just bend over backwards because they have to get someone of substance in there that has a good covenant and a long-dated lease. It’s just so necessary to get anchors and big users because there’s a lot of volume to fill.”

One answer to this, both in Australia and elsewhere in the region, may be to buy well-located existing assets that have early lease expiries. This will provide fast mark-to-market in terms of values, positive rent reversions, and the opportunity to upgrade older infrastructure that can deliver better rental growth going forward. This type of strategic flexibility is impossible in another fast-growing Australian alternative asset class (i.e., multifamily) because so few build-to-rent

projects have yet been delivered, leaving development as the only option. As a fund manager in Hong Kong commented: “The cap rates on industrial are a concern, but if you have confidence in the rental growth and cash flow, then it’s ultimately a better bet than buying a higher yield with something where the income may be reduced significantly. So I’d prefer to invest in something where we have better conviction it’s going to grow.”

Japan, meanwhile, saw several large logistics and data centre deals in 2023, partly as foreign buyers sought investments other than office and retail assets. Another catalyst has been a wave of reshoring of Japanese production capacity, particularly in the realm of semiconductor manufacturing.

Supply issues are looming, however, especially in the greater Tokyo area, with a large pipeline of new stock for 2024 adding to relatively high existing vacancies of around 8 percent. This is one reason for strong investment flows into Japanese regional markets.

Exhibit 3-10 Tokyo Bay Industrial Cap Rates, 2009 - 1H 2023



Source: CBRE.

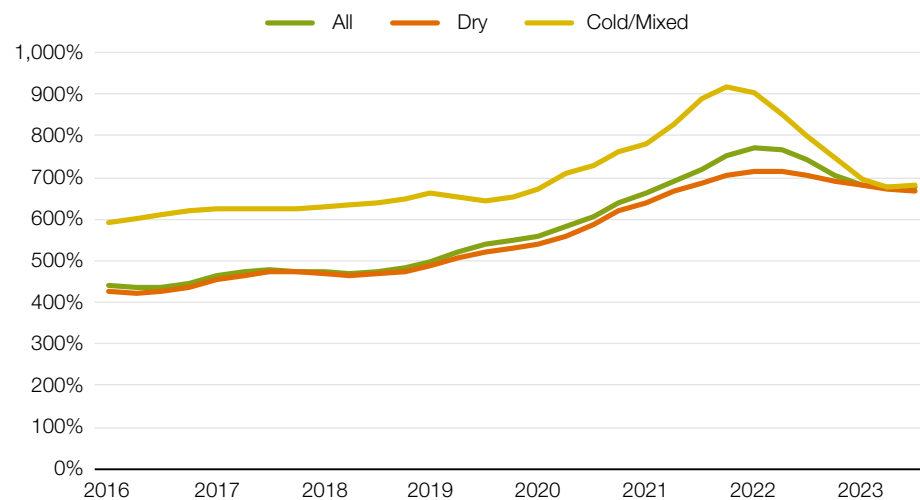
With so much capital chasing deals, cap rates as low as 3.65 percent as of mid-2023 mean that pricing has also become a concern. While still accretive, “the yield just doesn’t work,” at these levels, said one investor. “It’s so low it challenges what they expect by way of returns relative to other risk-adjusted assets. Basically, it’s the same as office, and in some cases it’s even tighter. In Australia, quality industrial logistics, again with the covenant and the end user in place, and with a long go-to-sleep tenancy that you can bank on, will be priced much better than office, because you just don’t know where [logistics] occupancy is going to be.”

Demand for new logistics facilities in Japan is likely to be boosted by a couple of ongoing trends. First, the “2024 problem” relates to impending regulations that will limit the number of hours Japanese truck drivers are allowed to operate. Given that truck drivers are already in short supply, this is likely to reduce Japanese transport capacity by some 14.2 percent nationally, according to a government study, and will oblige logistics operators to build new transit locations between large cities.

Another trend in Japan (mirrored in markets such as South Korea and China), is a shift towards growing use of multi-storey facilities in the wake of rising land costs and population densities in big cities. According to an executive at a large regional logistics provider: “When you think about it from an end-user perspective, the majority of the cost in terms of supply chain is not rentals, it’s transportation and labour costs. So if [occupiers] can shorten their transportation costs and attract more labour in a more urban environment, they can save a lot of money, even if they have to pay higher rents because construction costs for going vertical are greater.”

Finally, South Korea continues to digest a glut of logistics stock resulting from a two-year period of overbuilding. Around 12.6 million square metres of new construction began in Seoul in 2021 and 2022, compared to an equivalent amount of 13 million square metres in the much bigger Japanese market in the same period,

Exhibit 3-11 South Korea Warehouse Pricing by Type, 2016 - 3Q 2023



Source: MSCI Real Capital Analytics.

according to MSCI. As a result, banks in South Korea have become very selective in their lending to logistics projects. In addition, stress is emerging and pricing has moved out, though with prime logistics stock trading at cap rates of 5.0 to 5.5 percent, the increase has not been enough to satisfy potential buyers.

## Data Centres

A decline in data centre deals in 2022, when regional investment fell some 64 percent, does not accurately reflect real levels of activity in the market given that the vast majority of capital being directed into the sector is arriving by way of development projects.

This surge in development projects is occurring partly because demand appears bottomless. Not only is data consumption across the region growing from a lower installed base of infrastructure than in the West, but penetration of e-commerce retailing and high-speed 5G connectivity is generally higher – and often much higher – than anywhere in the world. It is also because modern data centres require such significant upgrades in terms of space and sophistication of mechanical and electrical equipment that older facilities are increasingly becoming obsolete.

Excluding China, the estimated value of new projects that broke ground in the Asia Pacific in 2022 reached about US\$15 billion, according to MSCI, compared to just US\$2.4 billion spent on standing assets. In the first half of 2023, a further US\$9 billion in new construction also commenced. One aspect of market dynamics that changed significantly in 2023 was geographic. While tier 1 markets like Japan and Australia dominated in the previous two years, the focus has now shifted towards emerging markets, in particular India and Southeast Asia (Singapore excepted).

## AI Changes the Game

The overall data centre market continues to be driven by facilities based in larger campuses serving cloud and 5G applications. Latency is important for these centres, although not as important as for edge data centres that provide cached content to end users on a virtual basis.

In 2023, however, a new catalyst arrived: artificial intelligence (AI) applications. According to a Singapore-based fund manager: “The density and energy consumption of the new Nvidia chips driving these AI data centres mean [the facilities] become much larger, so the market is going from talking about

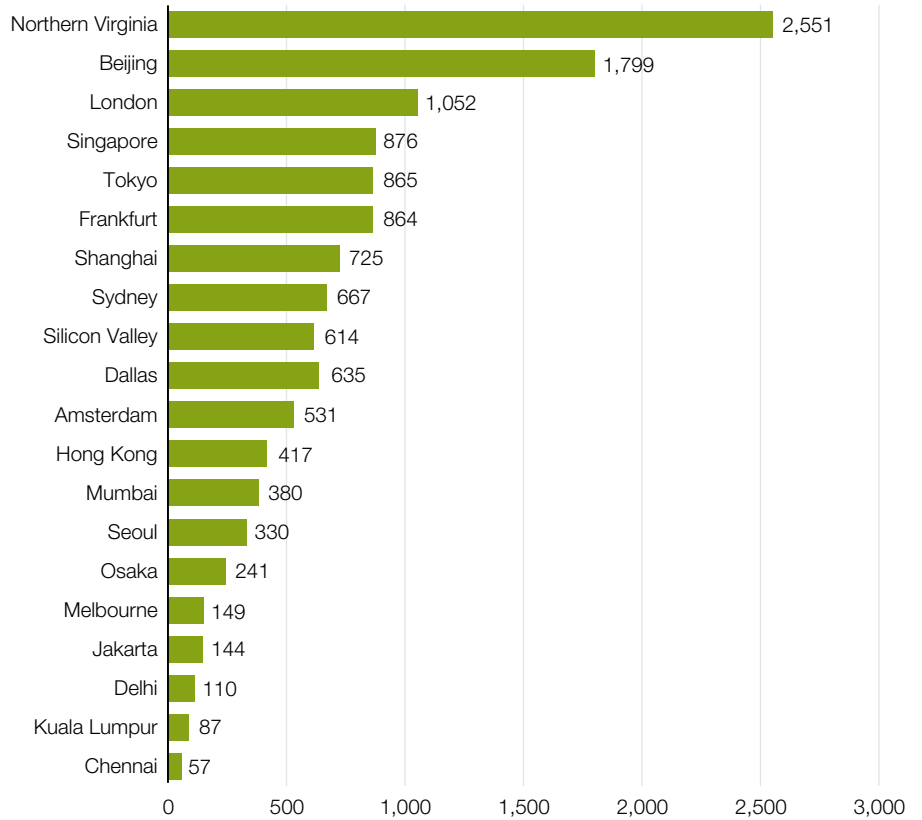
megawatts to gigawatts. Everyone is trying to figure out what that means, but the long and short of it is that the scale of the opportunity is much bigger than it was 12 months ago.”

As a result, demand for data centre capacity is set to increase by an order of magnitude. According to an executive at a regional data centre operator: “Even a year ago, there was leasing demand for [only] 10 to 40 megawatts at a time for large cloud deployments. But now the demand has shifted, so we are talking about 50 to 100 megawatts in Asia – and that’s only going to multiply in terms of both scale and location. Not many data centres in the region right now are even 50 megawatts. Singapore put in their ban a few years ago and most data centres there are under 10 megawatts. So is 50 megawatts now going to be bite sized?”

One noteworthy feature of facilities servicing AI needs is that, unlike other types of data centres, they mostly do not require high-latency responses, meaning they can be built in remote locations (Malaysia’s Johor, for example) where energy is cheaper and they will not cannibalise the workloads of facilities in densely populated areas. Subject to power availability issues, this also means that, in principle, AI-oriented facilities can even be shunted to locations situated in colder climate zones such as Japan’s Hokkaido prefecture. This will result in lower energy consumption – an important consideration given that their density and processor-intensive configurations generate so much heat.

This rapid evolution of a market for AI infrastructure may disrupt the way that data centres have traditionally been distributed geographically. According to a fund manager involved in numerous data centre investments: “We think that because of AI and machine learning, we’re going to see an increasing bifurcation between the very urban, edge, data centres for users with important latency requirements, and the AI and machine learning, quite a bit of which will move to hub locations where ability to deliver significant scale and sustainable power are going to be the

Exhibit 3-12 Data Centre Market Size by Power Capacity (MW), H1 2023



Source: Cushman & Wakefield Research.

key drivers. So some of these middle locations that are now serving those low latency [apps] or that aren’t sustainable and scalable may fall away over time.”

From an investment standpoint, data centres differ from many other alternative asset classes in that they are extremely capital intensive and can therefore easily satisfy the scale that investment funds are typically seeking for capital deployment mandates. If anything, in fact, the investments involved are so large that they are often carried out as club deals as a means to reduce both capital requirements and development risk.

The fact that data centre development is so capital intensive and time-consuming means that gauging local supply/demand dynamics can be difficult, especially for investors that come to the sector with little experience. As one fund manager said: “It does take time for these hyper-

scalers to ramp up, so, particularly if you’re doing it within a fund, and even though long-term supply and demand is in your favour, you could find yourself in a situation where you’re launching into a supply glut. And if that happens and you don’t have any unique solution-providing expertise, you’re going to be a price taker. So I think the data centre story is going to become a tale of two cities – you’re going to have circumstances that deliver strong results, and there’s going to continue to be some ugliness in the region.”

Still, in combination with ongoing construction delays and power-delivery challenges, new demand is such that vacancy rates continue to decline as the stock of newly built supply struggles to keep up. Vacancies in Tokyo and Hong Kong declined from 3.5 percent to 2 percent year-over-year as of mid-2023, according to CBRE, with Singapore’s

record-low vacancies of under 2 percent remaining the tightest in the region, while also driving the highest fees. At over US\$300 per month for a 250-300 kilowatt requirement, the city has the highest colocation rental rates in the Asia Pacific and some of the costliest in the world, according to CBRE.

### Power Problems

The most critical part of building out new data centre capacity continues to be obtaining a reliable source of power from local utilities. Even where local grids have sufficient capacity, the intensity of demand from any given facility is such that delivering it on site can be a challenge. Good connections with local utilities and government authorities can therefore be key to finessing energy delivery issues.

Another problem concerns energy efficiency. Because data centres are by nature extremely energy intensive (collectively accounting for 1 to 1.3 percent of global electricity demand in 2022, according to International Energy Agency figures), both regulators and limited partners (LPs) require them to meet ever-higher standards of power usage effectiveness (PUE). Achieving this can be expensive, however, driving up development costs. Average annual PUE for large data centres globally stood at a reported 1.55 in 2022, but regulatory limits in the Asia Pacific continue to push this figure lower. In particular, China and Singapore have stringent power consumption thresholds that have held back construction of new data centres. New projects in both Singapore and Shanghai, for example, must reach a PUE of 1.3, while in northern China levels have been set as low as 1.2.

Because cooling systems account for about half of total data centre energy consumption, increasing cooling system efficiency can reduce energy intensity drastically. As already mentioned, one way to do this is to build data centres that process low-latency type work (including most types of AI) in colder climates. Another way is to develop new cooling

technologies. In Singapore, which has arguably the most stringent regulatory regime in Asia, the government has approved construction of ocean-based data centre modules that will feature seawater cooling systems and be powered by liquid hydrogen shipped from Australia. First deliveries are expected by 2030. Immersion cooling systems – which can reduce energy needed for cooling purposes by as much as 97 percent – are now coming of age, and will be widely adopted by newly constructed data centre projects.

A third energy efficiency option is to use green energy, a strategy often imposed on operators by their investors (and sometimes by regulatory fiat). While some data centres will install renewable energy systems on site, the power requirements of a typical data centre are so great that to make any realistic impact, green energy needs to be outsourced, which can be done either through a local utility (if available), or more commonly, via a power purchase agreement with an independent renewable energy producer. Some investment funds are now buying renewable energy producers with the intention of integrating green energy production with their in-house real estate assets, as well as selling it elsewhere. Data centres are an obvious source of demand.

A final way in which data centre markets are evolving concerns data security. Over the last few years, an increasing focus on security among regional governments has led to the introduction of regulations that prohibit storage of sensitive (and even non-sensitive) data in cross-border facilities. As governments fine-tune these laws, however, offshore data processing functions will probably be allowed. This should help boost development of data centre mega-hubs in favourable power-generating locations.

According to an investor active in Asia Pacific data centre development: “It seems increasingly that there’s going to be an allowance for data to be processed in hub locations so the data can be sent offshore and processed, as long as the

original data and the processed data end up being stored onshore. That’s going to allow for a lot of the batch processing that AI and machine learning require. So it will be a net positive, but it is also changing the landscape.”

### Retail

After several years of downbeat sentiment, when conventional retail sales were pummeled by COVID lockdowns and rising online sales, investors are finally voicing an acceptance that the worst of the downturn has passed. Certainly, in terms of investment prospects, shopping malls across the region currently seem better placed than the average office asset. Although weak economies and rising inflation are threatening to impact consumer spending, retail occupancy is generally good, asset prices are lower, bid-ask spreads are narrower, and same-store sales are healthy. This has created a reasonable expectation that retail rents will begin to rebound after years of weakness. Survey results confirm that retail sentiment is now trending upwards (see exhibit 3-2).

As a Hong Kong-based fund manager said: “Retail has been unloved, but perhaps today the challenges are more cyclical because most of the structural story is now out there. So it may be that retail is showing signs of either bottoming or being close to the bottom.”

Where that leaves investors in terms of deal underwriting is open to question, though, because even if asset prices have fallen, higher interest rates still leave cap rates in most markets looking very compressed. That may be why rebounding sentiment has yet to surface in recent transaction statistics, with only US\$3.2 billion in deals recorded regionally during the third quarter of 2023 – the lowest quarterly number since 2009, according to JLL.

As a Singapore-based analyst commented: “It plays out where income and cap rates collide. With interest rates



rising, cap rates should go up too, so capital values will come down by virtue of that. But for retail in Singapore, the income story is really positive – from a very low base, rents are definitely starting to stabilise and move back up. So the actual capital value might not need to adjust that much as long as the income can offset it.”

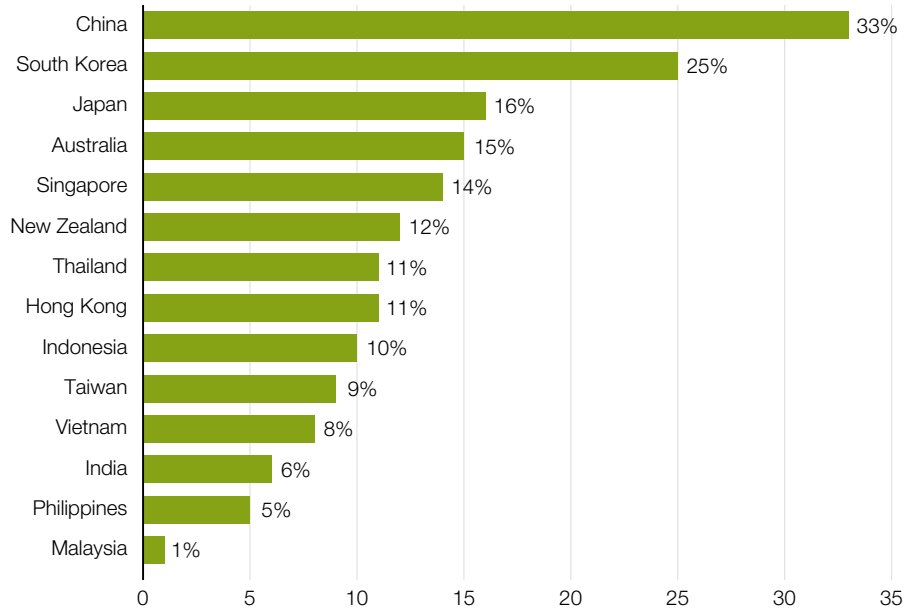
While the turning point may only come once investors accept that rising rents are sustainable, a consensus seems at least to have been reached that the predicted Armageddon in traditional retail will not materialise. An important factor that has supported the sector in the Asia Pacific is that one of the biggest components of the shift to internet retailing has been in the food and beverage (F&B) arena, with fulfilment completed by restaurants that still occupy brick-and-mortar premises. In general, also, omni-channel is expected to emerge as a more important model in the Asia Pacific than elsewhere, which should again help support demand for retail stores. Otherwise, although the retail mix has changed, the decline in occupancy is not nearly as ruinous as feared. As one interviewee put it, “This was the future – we’re now here and it’s not so bad.”

### Identifying Dislocations

Given lack of clarity on interest rate movements, valuations, and consumer spending patterns, buyable prospects are difficult to identify. Usually, however, they involve exploiting either a dislocation in the market, or a change in consumer-spending patterns. Probably the most prominent opportunity involves the region-wide oversupply of large mixed-use malls built in the 10 years before COVID, when the Asia Pacific was awash in tourists, many from Mainland China. These “copycat” malls often sprang up in non-central locations, competing vigorously to persuade brands to relocate to them. They usually offered little differentiation, but with millions of tourists driving footfall and sales, this mattered little at the time.

Today, with tourist numbers well down and any rebound to previous heights unlikely in the near future, large amounts of copycat space remain underused. Not

Exhibit 3-13 **E-commerce Share of Total Asia Pacific Retail in 2022**



Source: Statista.

all of this capacity will be salvageable, but for marginal properties, at least, the strategic focus has been to create “points of differentiation” and repurpose them to different uses. “If we have a million square feet,” said a Hong Kong-based retail specialist, “we can tighten up half of that, run it as well as we can, and then look at other strategies that point the way to finer-grain assessment of the consumer base.”

The repurposing exercise has led to large amounts of surplus space being recalibrated in ways that orientate it in the direction of local consumers, be it through F&B outlets or any mall-based leisure activity other than shopping. “The concept has effectively been borne out”, said the specialist, “so retail centres are now operating as a daily habit, as places where people use them as a mini part of the city.”

Repurposing big malls is a strategy imposed on owners because of oversupply, which in turn is a result of poor planning. While construction decisions in the past, therefore, were often somewhat spontaneous, the failure

of so many retail projects built over the past 10 years has served to impress on developers the importance of proper analysis. As one interviewee said: “The intelligence of these markets is improving rapidly because they’re realizing that if that you overcook it [i.e., build too many malls], then it fails – we’ve seen the evidence of that all through Asia. But if you’re smart, then it can work; so a lot more people today are sounding like they know what they’re talking about, whereas 10 years ago they just wanted to build a million square feet down the road.”

Importantly, however, poor planning in the retail world has not been limited to overbuilding large shopping centres: it includes also general inefficiency in developing a spectrum of different asset types that people need or want. As a result, the emphasis today has moved away from large retail formats and towards creation of niche, often sophisticated strategies, either by way of amendments to existing developments or construction of new stand-alone projects. In practical terms, interviewees identified various ways in which the market is evolving:

- F&B has become a staple alternative for mall repurposing purposes, although with options already much expanded, this theme has largely played out.
- Entertainment facilities have proved a reliable way to increase footfall, although high costs and low rent mean this theme can only be pursued so far.
- Improving the public realm has become an increasingly important strategy. The idea, according to one retail consultant, is “to create a place that’s very cool, and that still has restaurants and entertainment, where people want to hang out and relax. It marries up the economics of entertainment, with the food being that entertainment. So if you can make that work from an economic perspective, it can subsidise to a degree the entertainment you wrap around that. That’s an area of real growth that can help create something differentiated from what people have at home.”
- Outdoor space was a theme that came to the fore during COVID because it was seen as safer than indoor venues. In China, for example, outdoor-style malls thrived because operational constraints were lower. Although it comes with higher maintenance costs, the format has remained popular, with some newly developed malls in China incorporating impressively designed outdoor elements. According to one interviewee: “This is landlord-led public space that surrounding tenants benefit from. It’s a value-of-place proposition – people are starting to understand there is value in place making.”
- Convenience neighbourhood retail is a concept that plays to emerging patterns of consumer spending. A focus on non-discretionary products makes it less at risk of consumer retrenchment if economies weaken, while demand for local shopping options is

increasing due to rising numbers of work-from-home employees. In some markets, such as Australia, Hong Kong, and to an extent Singapore, this format is already well developed, but elsewhere the concept remains unexplored or poorly executed. According to one retail analyst: “To me, that space is the most interesting. Big malls are hugely oversupplied, and the sub-regional mall space is tricky – it gets hit hard by online because if you don’t have scale, that leaves you vulnerable to the impact of online. But neighbourhood is interesting because of that food and grocery convenience space and because not many people are doing it well. I think that’s a real growth opportunity, basically, to finalise the retail hierarchy from a shopping centre perspective.”

## Residential

The “beds” sector has been a favoured investment strategy globally for many years, with multifamily assets alone representing some 33 percent of worldwide transactions in 2022. In the Asia Pacific, however, the emergence of “beds” as an investment theme – apart from hotels – began only recently, as investors began to migrate away from a diet of levered bets in mainstream office and retail assets.

The recent growth in demand for beds-related assets arises because they are collectively able to tap tailwinds of demand that make them resistant to many of the risks posed by current market conditions. They include in particular residential, student, and senior housing facilities that had not until recently been targets of institutional investors outside of Japan (for multifamily) and Australia (for student and senior housing).

The most prominent sub-type is the multifamily sector. Build-to-rent residential emerged from relative obscurity a few years ago and featured as the only regional asset class where transactions increased in the first three quarters of 2023, according to RCA (see exhibit

1-19). Nor was this growth mainly limited, as before, to Japan, the traditional multifamily leader; buying was instead distributed across leading markets in the region, especially Australia and China.

The recent wave of build-to-rent activity in the Asia Pacific has been led by global institutional investors – often insurance companies and pension funds – seeking reliable, long-term income streams to match their in-house liabilities. Their short leases are a major draw for investors. According to a Sydney-based fund manager, “Multifamily is attractive because of its inflation-linked cash flows – there’s the ability to mark-to-market rents on an annual basis, whereas for an office lease you’re locked into five- or 10-year lease agreements with less protection to match to inflation.”

Because these global funds already hold large multifamily portfolios in the West, where the asset class is considered mature in many markets, the largely untapped opportunities in the Asia Pacific provide them an ideal way to meet global allocation targets.

The long-term strategies adopted by these institutions means their underwriting criteria are generally less demanding than those applied by local real estate investment trusts (REITs) and private equity funds, allowing buyers to bypass the problem most closely associated with regional multifamily development: high housing prices that generate correspondingly thin rental yields. Because cap rates are so compressed, however, investors must tread a fine line given a multitude of risk factors in the shape of rising interest rates, affordability and rental growth prospects, home pricing movements, currency fluctuations, development costs, consumer preferences, demographic trends, and tenant turnover, among others. As a result, there is fierce debate as to whether current multifamily strategies will prove profitable.

While the answer to this question is likely to be years in the making, conditions on the ground in 2023 have evolved in ways that have proved favourable for

the industry. In Japan, which currently accounts for the vast majority of regional multifamily housing stock, interest rates remain low at around 70 basis points, creating little pressure for cap rates of 3.00 to 3.25 percent to expand. At the same time, rising home values are pricing more potential buyers out of the market (thereby increasing the captive audience of renters) just as the net flow of workers into Tokyo turns positive for the first time in years.

Finally, prospects for rental growth, which many analysts had previously questioned given Japan's long track record of static residential rents, seem to be improving. A multifamily operator in Tokyo commented that increases of 1.0 to 1.5 percent were achievable, although anything beyond 2.0 percent was challenging due to low tenant turnover. "When you manage single units for one or two people it's relatively easy," he said, "because you have average turnover of 20 to 25 percent per year, and when people leave you can just increase your rent. But during the term of the lease, increasing rents is almost impossible. It's also far easier to increase

rents if you have bigger unit sizes. But it comes down to managing the portfolio on a pretty granular level. It's not just looking at rental growth; it's also about advertising the property, how quick are you to market, what the downtime is. If you get it to within 60 days then that's market, but 30 days is quick."

One recent change to Japan's multifamily market is that the number of offshore investors has declined. Although Japan is often identified as the only regional market in which many foreign funds will currently consider deploying new capital, some global investors have opted for now to suspend offshore investing altogether, while others have already reached targeted allocations (see exhibit 3-14).

As a result, domestic investors are now playing a bigger role, although because they tend to favour smaller purchases, demand in the market for scale has changed. According to one Tokyo-based fund manager: "In the past, there used to be a significant premium for scale and size, but large portfolios now are struggling to trade. We came across four

to five large portfolios over the last six months, and they are still on the market – so now brokers are starting to break up [large] portfolios to give more liquidity."

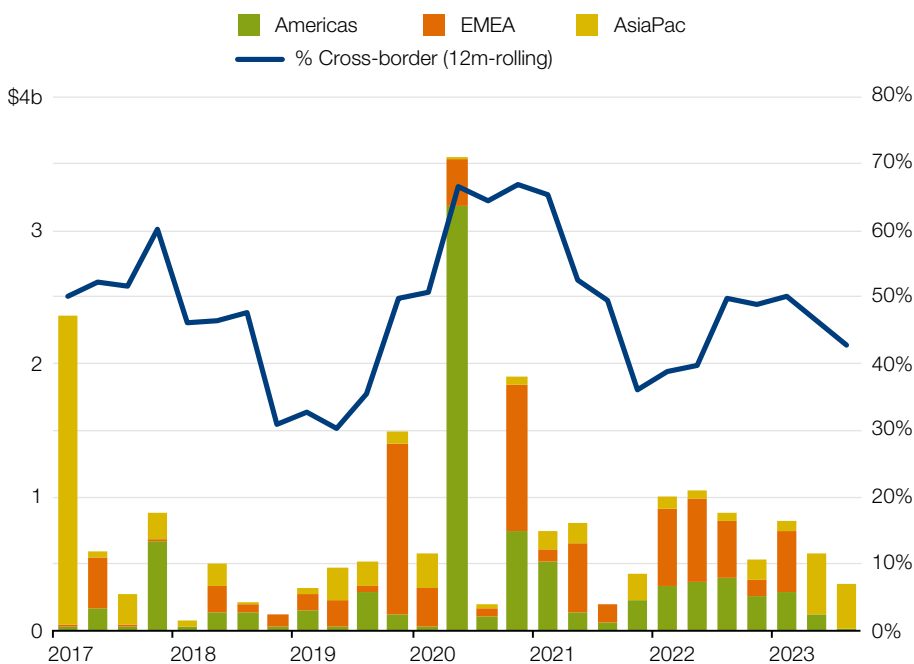
Another issue concerns forward-purchase strategies, which have become popular in recent years given the overall shortage of completed properties available to buy. On a regional basis, development risk is generally considered to be high given current economic conditions, but in Japan the situation is different. In the words of one large multifamily investor, "The way we structure transactions, we are able to de-risk construction cost risk by getting the general contractor involved early so we can have a lot more certainty about where costs are going to be. Also, because development timelines are shorter, the planning processes are clearer, and the time frames are essentially more compressed relative to other markets, [so] you're able to underwrite that construction cost risk with more certainty."

According to another fund manager: "Construction costs have been up 20 to 30 percent, but what's happened is that developers are much less demanding in terms of margin. And because [project] prices are still going in the right [i.e., upward] direction, development still works. But there will come a time when prices will become too tight, and then developers will be under pressure."

In China, strong potential for multifamily investments has made build-to-rent the single most favoured strategy for foreign funds. This is because, once again, structural tailwinds remain favourable despite widespread distress throughout the greater residential development sector. Demographic trends, in particular, continue to be supportive, with a large floating population of young professionals either unable or unwilling to buy properties given the economic and real estate sector downturn.

Government support of the sector translates to various policy and regulatory initiatives that smooth the passage of build-to-rent deals. In addition, investors can obtain local-currency financing from local banks on terms more favourable to those offered by offshore banks. Finally, investors stand to benefit from an

Exhibit 3-14 Quarterly Cross-Border Flows into Japan Multifamily, Q3 2023



Source: MSCI Real Capital Analytics.

increasing number of exit options. These include newly established domestic REITs that have recently been authorised to buy residential assets, together with an increasing number of well-endowed domestic institutions looking to build portfolios of income-producing assets.

The typologies of Chinese multifamily accommodation pursued by foreign investors fall into two groups. The first is mid- to upper-market high-rise apartments aimed at young professionals. This type of housing will usually be closer to city centres and will often be bought en bloc by a foreign fund at a discount from a stressed or distressed developer before conversion to multifamily use.

The other model involves more densely configured commodity accommodation developed (or possibly repurposed) by a specialist operator. Aimed at a more youthful audience – often newly graduated university students – these units have cheaper rents, and a community-oriented, co-living theme. The model is scalable, and although most development to date has occurred in Shanghai, it is likely to be rolled out on a widespread basis in various tier 1 cities over time.

According to one foreign fund manager who has recently invested in multifamily assets in China, “You can either buy land, start fresh, and build a bespoke product, or buy an existing asset at a discount to replacement cost from a stressed seller and look to convert that into multifamily apartments. That’s a shorter time frame and perhaps less risk, but it means you will be constrained by ceiling heights and elevator locations and the like for the physical asset, because most of them are built for a different clientele and a different market. For example, they might be multi-bedroom assets in suburban locations, whereas what you really want are studio apartments next to where people work.” In practice, most recently completed deals have been of the latter type.

Finally, in Australia, evolution of the currently nascent multifamily industry is supported by a number of structural demand drivers. First, with rental property vacancies registering less than 1 percent

in the third quarter of 2023, there is an acute shortage of capacity, due partly to rebounding immigration and partly to a construction industry downturn. Squeezed by both labour shortages and a sharp rise in construction costs, soaring builder bankruptcies in 2023 have drastically reduced the pipeline of new homes.

As a result, rental costs are rising steeply. Sydney saw a 16 percent year-on-year increase as of October 2023, according to SQM research, with little prospect of relief. This has played into the hands of multifamily operators, whose products usually target the mid to high end of the market. Rising rents also mean that investors have become more willing to endure initially low cap rates given the prospect of higher rental yields over time.

Ongoing home shortages have had an equally inflationary impact on housing prices, despite the fact that high mortgage rates – at well over 6 percent in October 2023 – would normally tend to deflate home costs. As more people become priced out of the home-buying market, the pool of tenants available to the multifamily sector should continue to grow.

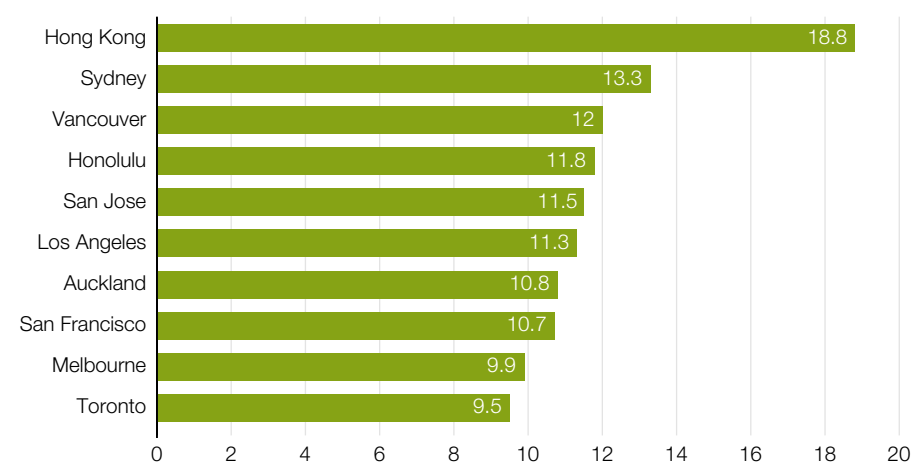
At the same time, and despite these catalysts, establishing a multifamily market in Australia promises to be tougher than in Japan. One of the main

obstacles is high development risk. Having watched as so many of their peers have been bankrupted, large construction companies are now unwilling to accept fixed-price contracts, leaving investors to bear the brunt of cost overruns.

Although a slowdown in construction cost growth in the second half of 2023 may help alleviate this, persistent questions remain as to whether Australian consumers are really open to participating in an institutionalised rental market, and if they are, what types of homes they may be willing to rent, where they should be located, and at what price points. Operational risk is therefore also high.

All that said, government support for creation of a multifamily market in Australia is strong, providing a degree of preferential treatment for build-to-rent development and implying a long-term future for the sector will be engineered one way or another. In particular, although significant regulatory risk (including convoluted planning and approval processes) still remains, the government has recently introduced policies – such as lower stamp duty, preferential access to land, and reductions in withholding tax for overseas investors, beginning in 2024 – aimed at

**Exhibit 3-15 Highest Median Property Price/Income Multiples among Metropolitan Markets as of Q3 2022**



Source: Demographia.

stimulating rental housing development. Beyond that, access to financing for build-to-rent developments is said to be easier (and cheaper, too, in the case of affordable housing projects) compared to equivalent for-sale projects.

## Senior Housing

Another subcomponent of the “beds” category is senior housing, which ranked as the Asia Pacific’s second-biggest alternative asset class in 2022 after life sciences, with transactions rising 43 percent in that year to US\$2.6 billion, according to MSCI. Apart from Australia, where the sector is now mature, the main focus of senior housing investment regionally is Japan, with REITs the main institutional player. Cap rates across Japan at the end of 2022 were around 5.2 percent.

While both the lack of supply and the demographic realities supporting demand in Asia are undeniable, investors have struggled to find a workable business model to facilitate widespread development of an institutionalised senior housing asset class. Despite widespread interest among interviewees, therefore, on-the-ground realities make it a challenging exercise. According to a locally based investor in Japan with experience in the space: “The problem is that a lot of people take care of their parents by moving in with them, so you don’t really have strong demand. And another issue is that a lot of the people managing this stuff are family or non-institutional operators that are not financeable, so aggregating is tough.”

A further problem involves the complex structure of existing senior housing projects, which involve establishment of a non-profit component, together with a for-profit medical services company, in order to qualify for government insurance payments. This convoluted operating structure makes the business opaque and has attracted, according to the investor, “a number of unsavoury characters who pull out all the money. So it’s a very difficult business. There are certainly some quality operators

out there, and to the extent that you can buy those assets, that’s great, but I have not seen it be scalable. Healthcare REITs have not bought many, if any, assets since IPO – the deal velocity is just not there.”

Another, Singapore-based, investor described a similarly challenging operational environment. “The number-one issue is that developers don’t want to be beholden to the operator,” he said. “In hotels, to some extent that’s also the case, but in healthcare, if you do assisted-type living for anything starting up the care curve, you have to have an operator who will want to dictate exactly what you need to do. And those relationships are not well established – the operator side isn’t mature enough; it just doesn’t exist.”

One way to address this problem is for development to be initiated by a group of doctors, or simply to buy a healthcare operator and operate the senior living side as a joint venture. There have been instances where a developer with existing residential assets has successfully adopted this strategy by simply bolting on a senior living component. In that case, however, the profits earned from the senior living side tend to be insufficient to move the financial needle. “They don’t make anything near the money out of senior living that they do from the hospitals,” the investor said, “so they would be better off putting their resources into technology to improve their margins and just create more hospitals.”

As a result, the independent-living approach, which is a real estate pure play, seems a more plausible option for most investment funds. In Australia, this is already a well-established institutionalised asset class with many different facilities, based on either the (somewhat controversial) “deferred management fee” model or the “land lease” community model.

Whether these might be applicable on a widespread basis in Asia, however, is questionable. According to one investor, “The issue is that you’re talking about a 30-year leasehold, and Asians don’t

buy residential 30-year leaseholds.” One potential exception to this is to create retirement communities in international destinations such as Bali or Phuket – an option already being pursued by some groups.

## Student Accommodation

Another form of operationally oriented residential accommodation is student housing. Again, the Australian template is well established, featuring a mature, institutionalised asset class underpinned by the high proportion (i.e., almost a third) of overseas students – especially from China – studying at local universities. The sector was hit badly when universities shut down and borders closed during the pandemic, but has bounced back strongly in 2023. Returns tend to be at a premium to conventional multifamily projects, and development is often incentivised by government tax breaks or preferential land purchase deals.

Significant numbers of interviewees expressed interest in investing in student accommodation, not just in Australia but across a number of Asian markets from Japan and Singapore to Vietnam and Indonesia. According to a manager of a large institutional fund with exposure to both the Australian and Japanese markets, operating models vary by market. In Australia, he commented, “we take on the operating risk, meaning we invest into a portfolio where the operator is selling the rooms, and our income is the net NOI [net operating income] after paying a fee to the operator. It’s similar to a management contract for a hotel, and it’s the same [model] as in the US and Europe.”

In Japan, however, the structure was reversed, with the fund divesting operating risk to the operator, who takes on a master lease and pays annual rent. “Usually it’s a better yield compared to multifamily,” said the investor. “But the challenge is that if you have a 10- to 20-year lease, indexation is very rare in Japan, so your NOI is going down because your revenues are flat for the duration of the lease, while your

expenses are usually indexed or subject to inflation. It makes a good mix with our multifamily assets because it gives us a blended portfolio, with an additional spread on your yield for student and senior housing, but at the same time the ability to boost returns by capturing rental growth on multifamily.”

Other investors expressed scepticism that student housing plays would work in Asian markets, citing problems in delivering scale (due to general lack of foreign students), together with a cultural preference for students to live at home with parents when attending university.

According to a Tokyo-based investor: “There are a lot of foreign students in Japan, so when you look at the data, you’d think you could have a student housing industry. But you don’t because, unlike in other markets, there are a lot of 25- to 30-square-metre single units that are rentable at very affordable prices. There are so many options, so there’s no reason to pay a premium to be in a student housing project. The international guys that have come in have tried it, but it hasn’t proved scalable and I don’t think it works here.”

### Hospitality

Following years of COVID-related gloom, the Asia Pacific hotel sector saw a strong rebound in 2023, with US\$3.2 billion in third-quarter deals making it the second most active asset class after multifamily, with volumes declining a relatively modest 7 percent year-on-year, according to MSCI.

While this strong performance was due in part to increasing numbers of deals in China, the real action was in Japan, where almost half of all third-quarter transactions took place. Japan enjoyed its best third quarter in nearly a decade, spread across a mix of portfolio and single-asset deals. Notably, Japanese hotels have been a particular favourite of cross-border investors, attracting more foreign capital than any other asset class across the Asia Pacific during the quarter.

Hong Kong is another market where activity is expected to pick up in 2024, as occupancies rebound due to a spike in Mainland tourism that should increase as outbound flights from China return to historical levels. Assets have already begun trading, often at deeply discounted prices compared to 2019 levels.

Although most hotel deals involve completed assets, chronic supply shortages have led some fund managers to pursue build-to-core strategies. Obtaining development loans may prove difficult, however, in the current environment. In addition, rising construction costs add to development risk. With CBRE projecting an overall increase in construction costs of 25 percent on average across regional markets (and as much as 40 percent in Japan) between 2020 and the end of 2023, many hotel development projects have been put on hold, further aggravating supply shortfalls.

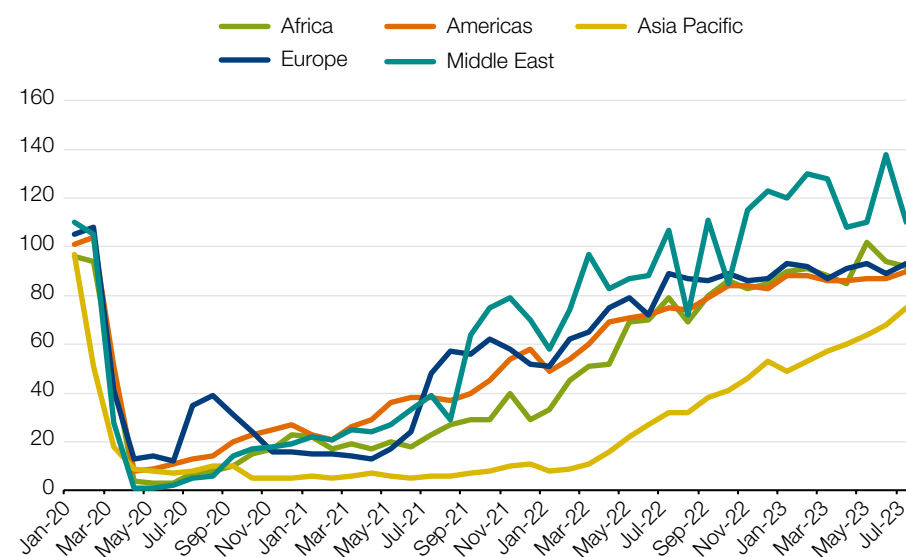
Although the prospects for rising revenues across the hotel sector are quite

strong, a wide gap persists between buyer/seller pricing expectations due to the lack of outward movement in industry cap rates. This has served to depress buying activity, and has left private investors, family offices, and high-net-worth buyers as the main players, given their ready access to capital and lack of pre-set hurdle rates.

Apart from this standoff over pricing, perhaps the single most important factor holding back the sector in 2023 has been the slow return of tourists from Mainland China, whose outbound excursions led to booming growth during the pre-COVID years. While tourist trips out of China are creeping up, they remain far from their previous heights.

Southeast Asia is currently the most popular destination for Chinese tourists, but arrivals have still not met expectations. The Thai government had projected as many as 5 million Chinese tourist arrivals in 2023, or less than half the 11 million in 2019. The first nine months of the year, however, saw fewer than 2.5 million arrivals – far more than

Exhibit 3-16 **Global International Tourist Arrivals, July 2023\***



Source: UNWTO.  
\* Percentage compared to same month in 2019.

the 250,000 in 2022, but well below expectations. Going forward, however, outgoing flows from China are expected to resume, in particular to previously favoured destinations such as Japan and South Korea.

Another problematic issue for the hotel sector is a chronic shortage of staff. In emerging markets, workers who were laid off or furloughed during COVID have in many cases declined to return once COVID ended because of generally poor pay and working conditions. In developed markets, meanwhile, labour restrictions prevent importation of labour, but locals have little appetite for hotel work. As a result, according to an executive at a Japanese hotel chain: “I haven’t seen any useful technology that will reduce labour costs, and this is a massive problem. Finding people is the Japanese hotel industry’s number-one challenge – most months we lose more people than we hire.” Staff shortages, which are felt across all markets in the region, have left many hotels able to operate only 70 percent of available rooms.

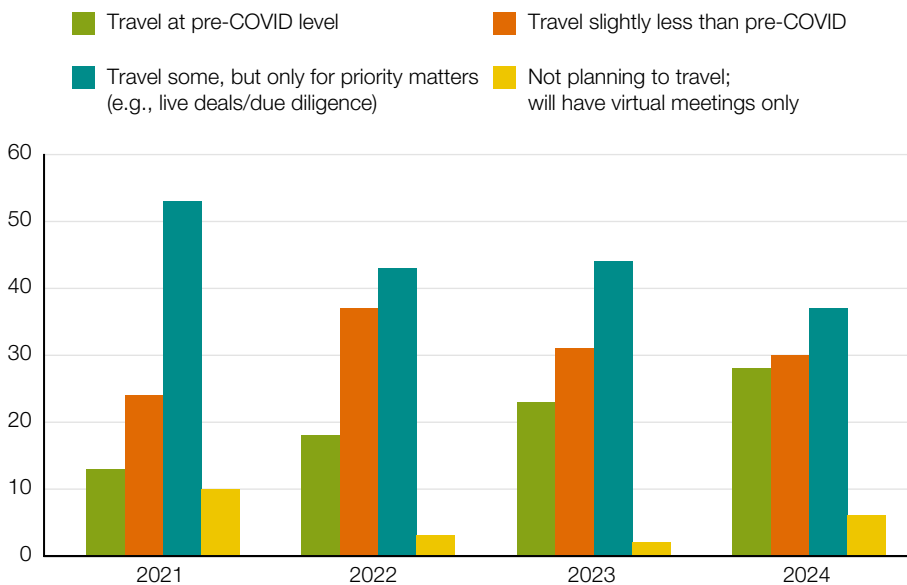
Hotels have become a focus for foreign investors for a number of reasons. For one, local residents deprived of international travel since 2019 are expected to embark on revenge-spending travel binges, meaning hotel occupancies should remain high for the foreseeable future. In addition, a significant number of owners who have been subject to years of financial stress may now be willing to sell their properties. Finally, the sector is seen as a relatively inflation-proof asset class.

As a fund manager in Hong Kong commented: “Hotels is still an alternative sector in the sense that you have daily pricing. But it is also a sector where specialists are able to outperform, and that’s the exciting part – figuring out what your specialism is within the hotel arena and then where that opportunity exists. And I think there’s a lot of that in Japan, whether it’s the top end that’s chronically undersupplied, or anything to do with international travel, which is the same. And then, converting, if you’re a value-add player, from economy to mid-scale hotels. At the same time, the problem

with Japan is that pricing has gone up so much in the last six months that it’s hard to make the numbers work.”

The same dynamic is in place in Southeast Asian markets, which were equally affected by the downturn in foreign tourism but have now rebounded, led by a wave of Indian and Russian visitors. According to a Jakarta-based analyst: “People were really squeezed or got behind on their bank loans, but in Bali things have bounced back, in some cases even better than they were doing in 2019 in terms of occupancy or rack rates. Still, you see people that need to sell because maybe they haven’t refurbished the hotel, they don’t have the money to do it, so they say ‘okay, now just get out!’”

Exhibit 3-17 **How have your business travel plans changed post-COVID?**



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.





# Interviewees

**Acacia Capital Partners**  
Kumar Kalyankakumar

**Actis**  
Brian Chinappi

**Altis/Barings**  
Alastair Wright

**Alyssa Partners Japan**  
Ken Fridley

**ARCH Capital**  
Winson Chow

**AXA IM Real Assets**  
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ULI's interdisciplinary membership represents all aspects of the industry, including developers, property owners, investors, architects, urban planners, public officials, real estate brokers, appraisers, attorneys, engineers, financiers, and academics. Established in 1936, the Institute has a presence in the Americas, Europe, and Asia Pacific regions, with members in 84 countries.

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## Emerging Trends in Real Estate® Asia Pacific 2024

What are the expected best bets for investment and development in 2024? Based on personal interviews with and surveys from 203 of the most influential leaders in the real estate industry, this forecast will give you a heads-up on where to invest, which sectors and markets offer the best prospects, and trends in the capital markets that will affect real estate. A joint undertaking between PwC and the Urban Land Institute, this 18th edition of *Emerging Trends Asia Pacific* is the forecast you can count on for no-nonsense, expert insight.

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## Highlights

- How investors are positioning for a post-COVID environment.
- Tells you what to expect and where the best opportunities are.
- Elaborates on trends in the capital markets, including sources and flows of equity and debt capital.
- Indicates which property sectors offer opportunities and which ones to avoid.
- Reports on how the economy and concerns about credit issues are affecting real estate.
- Discusses which metropolitan areas offer the most and least potential.
- Describes the impact of social and geopolitical trends on real estate.
- Explains how geographical and sectoral preferences are changing.



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