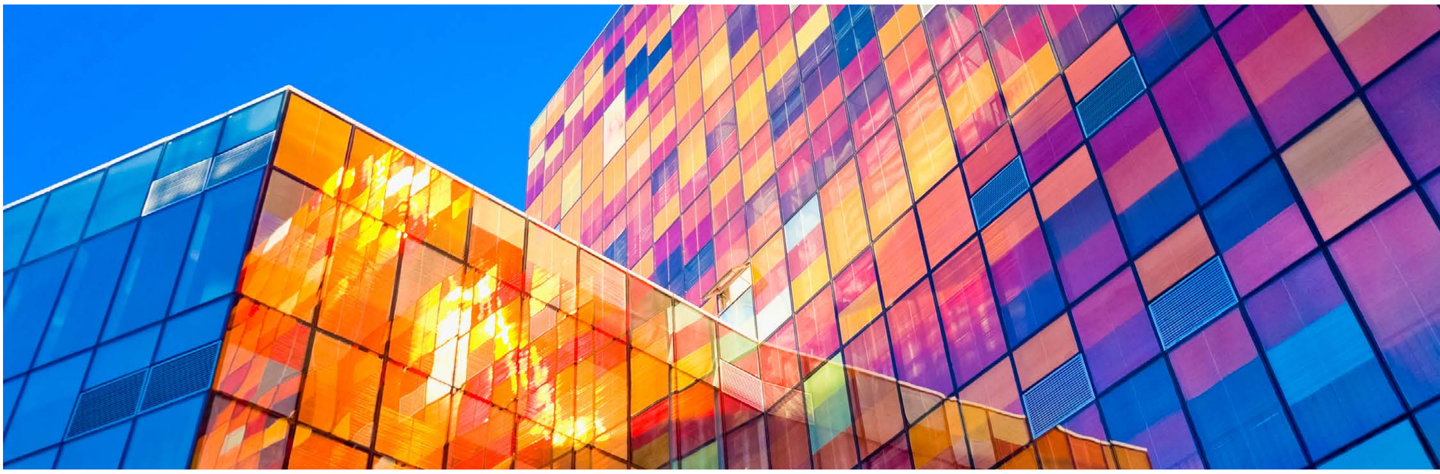

A multi asset perspective on Asian real estate

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New growth segments such as property management, logistics and data centres will create fresh opportunities for investors within Asian real estate. At the same time, China's three red lines policy will allow bond managers to add value through active credit selection of Chinese property bonds. We believe that a thoughtful curation of Asian real estate equities and bonds should continue to provide investors with a compelling income stream in a low rate world and offer diversification benefits to counter volatility.

Asian real estate remains an attractive asset class although COVID-19 has changed the face of the sector, potentially for good in some areas. The MSCI AC Asia ex Japan Real Estate Index currently offer yields of 4.3%, higher than the yields of the MSCI IMI US Real Estate Index (3.1%), the MSCI Europe Real Estate Index (3.4%) and the broader Asian market (1.9%)[1]. Meanwhile, current valuations of 8.1 times 12-month forward Price to Earnings Ratio represent about a 30% discount from its 10-year average[2]. The acceleration of structural trends as a result of the pandemic creates exciting long-term growth segments. At the same time, the normalising global economy presents tactical opportunities in oversold real estate sub-sectors.

Meanwhile, the JACI Real Estate Index currently offers a 572 basis point[3] spread above US Treasuries. New financing guidelines for Chinese property developers will help rein in leverage for the sector, while allowing active bond managers to add value through active credit differentiation.

THE CHANGING FACE OF ASIAN REAL ESTATE

Pre-COVID-19, Asia's real estate sector was largely focused on retail, residential, hospitality and office. Going into 2021 and beyond, data centres, technology parks and logistics will likely dominate the more traditional areas. Here we highlight two upcoming growth segments within Asian real estate equities that we favour:

Source: [1]As at 31 December 2020. The broader Asian market is represented by the MSCI AC Asia ex Japan Index. [2]Refinitiv, 31 Dec 2020. [3]JPMorgan, Bloomberg, 15 February 2021.

Fig 1: Real Estate Indices – Dividend yield (%)

Source: Bloomberg, data as of 31 Dec 2020. World = MSCI World Real Estate Net Total Return USD Index. Europe = MSCI Europe Real Estate Index. AC World = MSCI ACWI Index. Asia ex Japan = MSCI AC Asia ex Japan Real Estate Index. United States = S&P 500 Real Estate Index.

Industrials

The increasing penetration of e-commerce in Asia Pacific will continue to drive warehousing demand. E-commerce in Asia Pacific is already a USD2 trillion market[4] - the largest in the world - and is expected to grow at a 100% compounded average growth rate to reach USD3.9 trillion by 2023. While some retailers have already developed sophisticated logistics platforms, late movers are likely to expand their e-commerce capabilities as buyer behaviours change permanently. This implies that industrial space in strategic, centrally located markets as well as last mile assets will remain in high demand.

Besides the impetus from e-commerce, the industrial sector is also poised to benefit from the recovery in trade as the global economy normalises. The International Monetary Fund expects global import and export volumes to rise 8.% yoy in 2021, a sharp reversal of 2020's 9.6% yoy decline[5]. Within Asia Pacific, the recent signing of the Regional Comprehensive Economic Partnership may also boost regional trade activity. CBRE expects logistics rents to rise across all markets in Asia Pacific in 2021, with Tier I Chinese cities leading the charge on the back of a recovery in leasing demand and limited urban supply.

Data centres

While COVID-19 lockdowns and social distancing measures weighed on economic activity in 2020, mobile data growth continued, unabated. Across different countries in Asia, mobile data grew between 25% to 71% in the first half of 2020 compared to the same period the year before[6]. The launch of new technologies such as 5G and Internet of Things will keep data growth elevated.

As consumers' data consumption surges for low latency, high performance activities such as online gaming and AR/VR, more data storage will be needed. Enterprises are also gathering more information on consumer behaviour, driving the demand for storage and data centres.

Source: [4]By gross merchandise value. BofA. October 2020. [5]International Monetary Fund. February 2021. [6]Citi Research. October 2020.

Beyond storage, the rising usage of AI and machine learning powered applications is also boosting demand for data centres. These applications often require extensive computing resources and power, which are typically beyond the capabilities of most companies. As such, data centres can help provide the necessary processing infrastructure.

The outlook for data centres in China is particularly encouraging. While the prices of Chinese data centre stocks which we track have on average doubled in 2020, we believe that greater digital adoption in China and supportive government policies will continue to help underpin valuations. China's cloud infrastructure services market is the second largest in the world, yet it is only one-tenth the size of the US'. At the same time, cloud computing only accounts for 2.7% of China's IT spend versus 11.4% in the US[7]. See Fig. 2.

These numbers reflect the tremendous upside in China's cloud market, and in turn for Chinese data centres. The potential is further augmented by the Chinese government's increasing efforts to digitise the economy and the rollout of the country's 5G network.

A POSITIVE DEVELOPMENT FOR CHINA'S PROPERTY BONDS

The fundamental outlook for the Chinese property sector appears generally stable on the back of an expected recovery in earnings and better liquidity. The major developers' contracted sales surged by 66% in Jan 2021 and are also expected to remain strong in February against the low base in January and February 2020. While the Chinese government had historically focused on moderating bubbles in the property sector through mortgage restrictions,

Fig 2: Spending on public cloud

	Total IT spend USD Bn	Public Cloud spend as a % of total IT spend (2018)
UK	137	11.4%
USA	911	11.4%
Canada	63	11.3%
Australia	48	7.7%
World	2,362	7.9%
Germany	103	6.9%
Brazil	40	7.9%
India	42	6.0%
China	172	2.7%
Russia	15	2.9%

Source: National Association of Software and Service Companies (NASSCOM).

Source: [7]The National Association of Software and Service Companies.

price caps, housing purchase restrictions and varying the criteria for the issuance of sales permits, the focus is now on the quality of growth and increased scrutiny on developers' balance sheets with the "three red lines" policy.

China's new financing rules require developers' funding activities to be assessed against three red lines, or thresholds. To put it simply, property developers have to ensure that i) every dollar of debt is matched by one dollar of assets, ii) every 70 cents of debt is matched by one dollar of equity and iii) there is sufficient cash to cover short term debt. Developers who meet all three thresholds will be allowed to raise new financing, but only up to 15% of existing debt. See Fig. 3. While the property developers are still waiting for details on the formulae for calculating these ratios, some of the highly levered large developers have been requested to participate in the 'trial' to meet the thresholds within 2021.

We believe that these rules will help to moderate the amount of risk taking and reduce overall leverage in the sector, which will be a long-term positive. At the same time, these regulatory defined metrics provide common measurements across the industry, helping to reduce the ambiguities arising from different reporting criteria across companies.

Active bond managers can add value through credit selection. For example, we are on the lookout for companies that should be able to improve their leverage ratios. Nevertheless, we plan to navigate the landscape carefully, as banks may seek to reduce exposure to vulnerable companies, potentially leading them to flirt with distress and even default. We currently favour the larger developers, which have better financial ratios and are likely to enjoy continued access to lending facilities. Meanwhile, the financing guidelines will also restrict new bond issuances, helping to keep net supply manageable which should support bond valuations.

NEW GROWTH SEGMENTS; FRESH OPPORTUNITIES

COVID-19 does not sound the death knell for Asian real estate. Instead, the evolving sector and new

Fig 3: China's new financing rules for property developers

China's three red lines policy	
1) 70% ceiling on the debt to asset ratio after excluding advance receipts	
2) 100% cap on net debt ratio	
3) 100% cap on the short-term debt/cash ratio	
No. of lines violated	**Debt growth permitted**
0	15%
1	10%
2	5%
3	0%

Source: Media reports.

growth segments will create fresh opportunities for investors. We are watching trends in property management, logistics and data centres closely. Meanwhile, changing needs and usage will shape the future of retail and commercial office space, potentially giving them a new lease of life. While oversold sectors present tactical opportunities, we are cognisant that the pandemic will continue to weigh on the hospitality sector if travel restrictions stay in place.

China is an important market given its sheer size and potential. Just as the three red lines policy has redefined how credit risk is measured for the Chinese property developers; we stay alert to new regulations that may impact China's broader real estate market. China's recent announcement that it will list its first REIT soon marks the first step in giving investors access to what could become a multi-billion-dollar market. We will be writing more about the roll-out of China REITs in the coming months.

By understanding where the risks and opportunities lie, we believe that a thoughtful curation of Asian real estate equities and bonds can provide investors with a compelling total return which includes a reliable and recurring income stream, in a world where interest rates are expected to remain low.

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