Undervalued real estate presents attractive opportunities

Pearly Yap, Portfolio Manager, Equity Income, Eastspring Investments, Singapore

Talk of the imminent demise of Asia's commercial real estate sector is greatly exaggerated. Malls that cater to domestic customers' preferences are still resilient but there are doubts over the relevance of office properties over the long-term given the Covid-19 induced work from home practice could possibly become common. Meanwhile, current market valuations present select opportunities for investors to access quality assets at prices not seen in years.

The Covid-19 pandemic has sparked widespread speculation that the commercial real estate sector, particularly malls and offices, is in decline. The typical thought process is that malls, already under pressure from the rise of e-commerce, will be unable to survive sustained movement restrictions and mandatory social-distancing measures. As for offices, the speed at which the work from home (WFH) culture has become normalised, coupled with employees' apparent preference for this arrangement, is predicted to spell doom for the segment.

This logic is not without some basis. For instance, transaction volumes have indeed declined considerably, falling by 32% year-on-year, according to data by real estate research firm, Jones Lang LaSalle (JLL)[1]. JLL also noted that the office, retail, and hotel segments were hardest hit, with logistics remaining the most resilient. The firm also recorded substantial valuation impacts in recent transactions within the office segment, with discounts in sale prices of 20–30% in Hong Kong and about 19% in China over 2018–2019 levels. See Fig 1.

Although Asia has handled the pandemic comparatively well, economic uncertainty remains high, which has pushed many investors into a "wait and see" mode. Consequently, rentals, capital values, and office net absorption have dipped while vacancies have risen[2]. See Fig 2.

There is no doubt that the Asian commercial real estate sector has been hit hard by the Covid-19 outbreak and is, in fact, the sector with the worst share price performance since the pre-crisis peak on 17 January 2020 according to Goldman Sachs data[3].

Source: [1]https://www.jll.com.mo/content/dam/jll-com/documents/pdf/research/jll-capital-tracker-2q-2020.pdf
[2]http://cbre.vo.llnwd.net/grgservices/secure/Asia%20Pacific%20MarketView%20Q2%202020%20FINAL%20_v2.pdf?e=1596525439&h=75fee05eed-48ae4de7190915aa298444 [3]Goldman Sachs: Asia-Pacific Portfolio Strategy: Asian equity market impact of viral outbreak: daily update, 1 September 2020.

However, investors appear to be pricing a short- to medium-term setback as a long-term downturn.

We believe that the market has overreached and is undervaluing the long-term case for segments such as malls, which are quickly pivoting, and offices where there are signs of long-term resiliency despite the WFH culture. On top of that, government support measures, such as tax and rental waivers, are also providing near-term relief, which is not being reflected in current pricing.

MALLS THAT SUCCESSFULLY PIVOT WILL WEATHER THE CRISIS

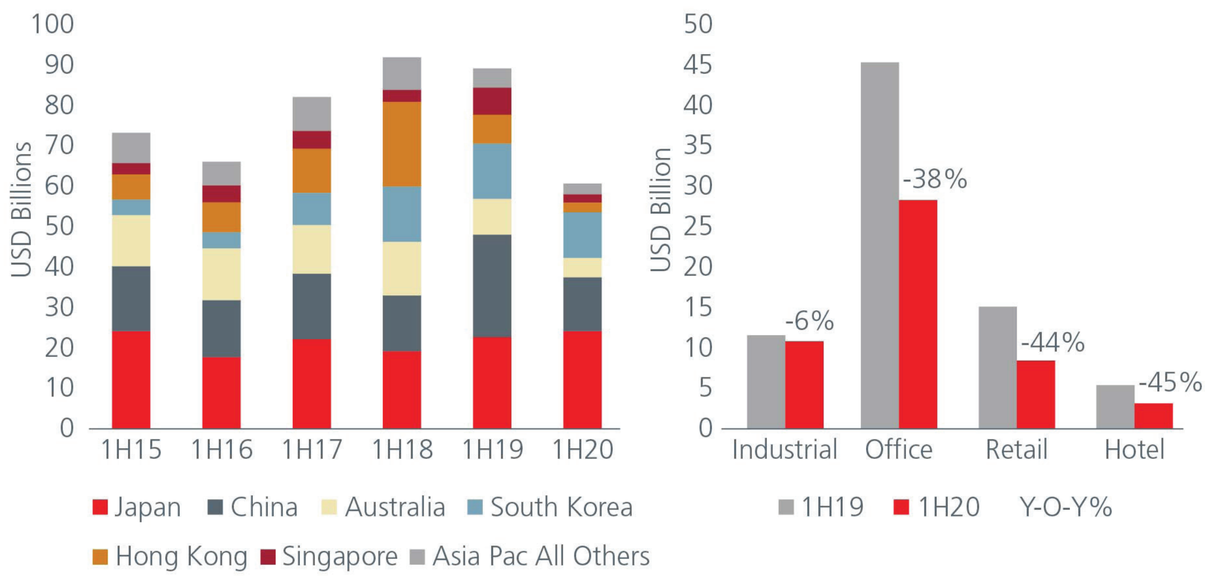
Although lockdown restrictions have been loosened in most parts of Asia, cross-border travel remains highly controlled. This has led to a complete absence of foreign tourists – the lifeblood of many malls, especially in Hong Kong. Furthermore, this sector faces more significant challenges compared to other parts of the commercial real estate market, in large part due to structural issues that existed before the pandemic, such as competition from e-commerce and high occupancy costs.

However, it would be a mistake to conflate the expected short-term declines in the retail space – no matter how dire – with its longer-term prospects. Also, not all retail segments are created equal. Malls that can shift their focus and try to capture local customers and deliver experiences that cannot be replicated online have a higher chance of successfully weathering the crisis.

We believe that two sub-categories should see comparatively higher rent growth[4]: suburban malls focusing on everyday goods and well-managed city centre malls with a good mix of shops, restaurants and activities and well-positioned transit links.

Examples of the first sub-category are Hong Kong's Hysan Place and the malls owned by LINK

Fig 1: Asia Pacific real estate transaction volumes by countries and segments



Source: Jones Lang LaSalle capital tracker report as at 2Q2020.

Source: [4]https://www2.colliers.com/download-research?itemId=966964f3-5af2-4c82-9f53-bb97441bc2bc

REIT, which is Asia's largest real estate investment trust. These properties cater primarily to the local population, with a tenant mix that weighs more toward "defensive" types such as supermarkets and also services such as dentists, hair salons, and tuition centres.

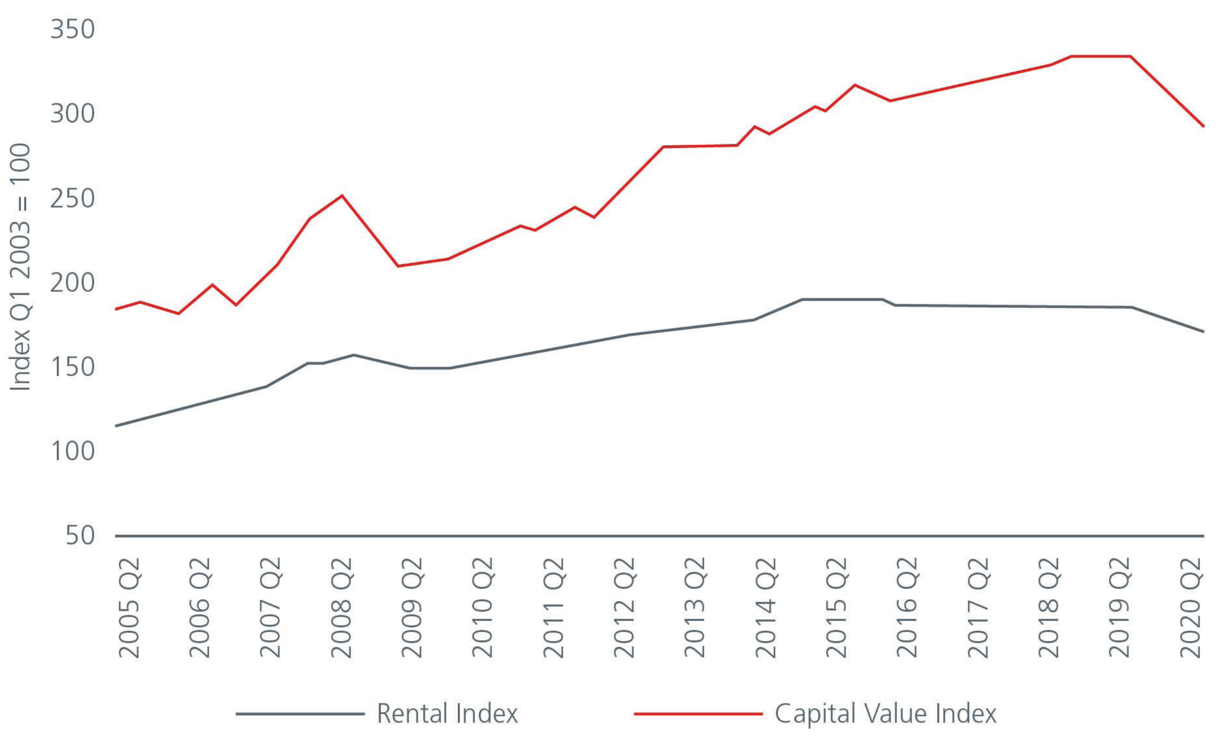
One notable example of the latter sub-category is Singapore's Funan mall, which mixes the retail with the experiential – boasting an indoor cycling lane, a rock-climbing wall, a futsal court, a cineplex that offers Virtual Reality (VR) experiences, and an edible "garden city", among others[5]. The mall is also considered a "phygital" mall – an integration of the physical and digital, with technology baked into its very design. For instance, visitors to its food court can place orders via Facebook Messenger while interactive billboards allow shoppers to browse items and add them to their wish lists[6].

NEW BUSINESS MODELS SUPPORT PHYSICAL RETAIL'S LONG-TERM RESILIENCY

New business models are also emerging to ensure malls remain relevant by complementing rather than competing with e-commerce. For instance, e-commerce giants, like Alibaba and JD, are expanding into an "omnichannel delivery" model, where they are opening physical stores to supplement their online presence[7].

Another case is Fillogic, a platform that allows malls to convert non-selling retail space into tech-enabled micro-fulfilment hubs. 60% of mall-based

Fig 2: Asia Pacific retail rental and capital value index



Source: CBRE Research as at 2Q2020. Note: The rental changes do not take temporary rental reduction into account but reflecting the rental changes in asking rents.

Source: [5]https://www.timeout.com/singapore/shopping/guide-to-funan-singapore [6]https://marketingmagazine.com.my/34066-2/ [7]https://realassets.ipe.com/consumer-trends/retail-all-aboard-the-aliexpress/10046550.article?utm_campaign=97414_21.7.20%20ipe%20ra%20daily%20news&utm_medium=email&utm_source=IPE&dm_i=5KVE,235Y,C64W7,7X6A,1

retailers already process e-commerce orders from their store, but they operate in silos. Platforms like Fillogic help them run as an integrated ecosystem, improving efficiencies and maximising mall's asset utilisation metrics[8]. Although only newly launched in the US, we believe that it is a business model that is likely to soon make its way to Asia.

Finally, it is worth considering the role that malls play here in Asia. They are not merely utilitarian spots for buying the same goods that could just as easily be found online. Instead, they play an important social function, especially considering the typically small and crowded homes prevalent throughout the region.

DESPITE WHAT WFH EVANGELISTS SAY, OFFICES ARE HERE TO STAY

Despite minor hiccups, most companies have managed to adapt to the WFH culture. This has led to many believing that remote working is always better than office arrangements and think that it will remain the default even in a post-pandemic environment.

But not everybody is happy with this arrangement. Telecommuting has led to a more extended working day, additional meetings, more emails, and a further blurring of the line separating work and personal time[9]. And in Asia, the aforementioned domestic-space constraints also play a factor (especially if living with extended families), creating an environment with more distractions. Meanwhile, some advantages of the office simply cannot be replicated, such as the ability for almost instant collaboration. As Knight Frank notes, *"Technology is transformative – but it will never replace human interaction"*[10].

Of course, it would be naïve to think that office culture will ever revert to the way it was before the pandemic. There will be an inevitable evolution. For instance, offices will likely become less densely packed because of stricter social-distancing measures (absent a global vaccine that completely inoculates the population). A hybrid model, where employees get to choose where they want to work from and with offices serving more as a "collaboration hub", may become more popular. Also, companies may consider proper office locations closer to residential towns than merely central business districts for a hub and spoke network.

TECH COMPANIES ARE (SURPRISINGLY) DRIVING DEMAND FOR OFFICE SPACES

When remote work was forced upon employers, tech companies were the quickest to adapt. It might thus seem intuitive to think that these companies would be the ones championing permanent WFH arrangements. Yet, data shows that it is these tech companies that are the ones currently driving demand for office space.

In its *Asia Pacific Market View 2Q20* report[11], CBRE notes that tech demand remains resilient, a view echoed by JLL[12]. JLL reported that the largest leasing deal signed in the first half of 2020 was by Bytedance, with Alibaba also purchasing a 50% stake in Singapore's AXA Tower for S$840m in May[13].

While the tech sector's relative outperformance compared to other areas of the market during the pandemic means that they have the financial capability to make such deals, their continued preference for physical office locations indicates that offices will always be a part of our working lives. As Google's former HR chief bluntly told the Wall Street Journal about permanent WFH: *"This is not going to be sustainable"*[14]. Yet, this reality is not being reflected in current market valuations.

Source: [8]https://www.insidelogistics.ca/dc-and-warehouse-operations/fillogic-opening-mall-based-distribution-hubs-171849/ [9]https://www.bloomberg.com/news/articles/2020-08-03/the-pandemic-workday-is-48-minutes-longer-and-has-more-meetings [10]https://www.knightfrank.co.uk/blog/2020/04/29/key-factors-that-will-shape-the-future-of-the-office [11]http://cbre.vo.llnwd.net/grgservices/secure/Asia%20Pacific%20MarketView%20Q2%202020%20FINAL%20_v2.pdf?e=1596525439&h=75fee05eed48ae4de7190915aa298444 [12]https://www.jll.com.mo/content/dam/jll-com/documents/pdf/research/jll-asia-pacific-property-digest-1Q-2020.pdf [13]https://www.jll.com.mo/content/dam/jll-com/documents/pdf/research/jll-capital-tracker-2q-2020.pdf [14]https://www.wsj.com/articles/companies-start-to-think-remote-work-isnt-so-great-after-all-11595603397

CURRENT MARKET VALUATIONS OUT-OF-STEP WITH LONG-TERM REALITY

Market dislocations create opportunities for astute investors – a lesson learned from the 2008 Global Financial Crisis. As mentioned earlier, we believe that markets are pricing in too much downside for the retail and office segments.

Although we are focused on the longer-term thesis for the mall and office segments, we also believe that there is near-to medium-term upside as investors re-enter the Asian commercial real estate market. For instance, JLL reports that there is an estimated US$40 billion in "dry powder" – unutilised capital – waiting to be deployed into the Asia Pacific region[15]. While lingering uncertainty has put a pause on a lot of these flows, the gradual influx of this capital as the situation improves in Asia should provide shorter-term price support.

It is also essential to keep in mind that, despite pressure on rents and valuations, real estate remains an attractive asset. For one, pressure on rents is not as great as the squeeze on corporate earnings. And given the prolonged "lower for longer" yield environment, real estate yields are still appealing. For instance, UBS[16] estimates the yields for property companies and REITs in Hong Kong and Singapore to be just under 5% - and expects them to grow to 5.5% and beyond over the coming years.

Beyond attractive yields, there is also the perception of being able to generate more stable cash flows. Further, the ultra-low interest rate environment, coupled with the flood of central bank liquidity, should also provide support to asset prices going into 2021.

While the market's undervaluation of the retail and office segments of the Asian commercial real estate sector has created bargains, caution must still be taken. Performance and recovery will not be uniform – even within segments and countries – meaning that careful research is required to uncover these opportunities.

Source: [15]https://www.jll.com.au/en/trends-and-insights/investor/crossborder-investments-will-potentially-accelerate-despite-the-short-term-pause-in-apac [16]UBS: Global Real Estate Key valuation metrics: c.200 real estate companies, August 2020

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