M&G REAL ESTATE

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APAC Real Estate Outlook

For Investment Professionals only

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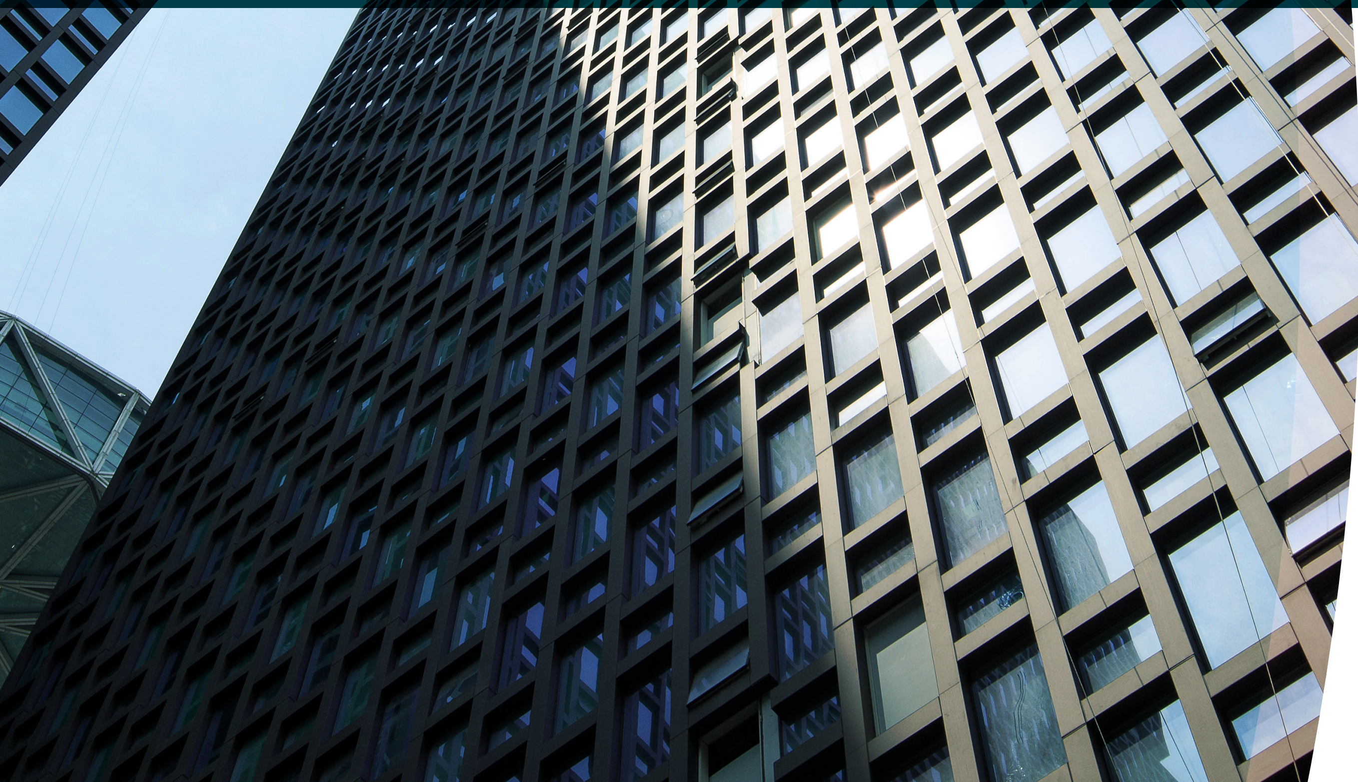
Executive summary

- The COVID-19 pandemic has accentuated the need for businesses to increase operational resilience and adapt faster to structural trends, particularly as economic uncertainties linger
- Real estate occupiers' needs and preferences are thus expected to evolve in line with trends such as increased automation, telecommuting, omni-channelling and smart living on the back of further digitalisation
- Demand for logistics space in key developed APAC markets is likely to rise on the back of growing e-commerce and businesses' potential reshoring and/or excess capacity built into businesses' supply chains
- Rents for high quality office and retail assets – in terms of building specification, services and flexibility provided to occupiers – are likely to continue outperforming as 'hotelisation' of these sectors become commonplace
- Multi-family housing in key Japanese cities is expected to continue recording stable income streams, with cities still critical for economic digitalisation due to economies of scale and agglomeration

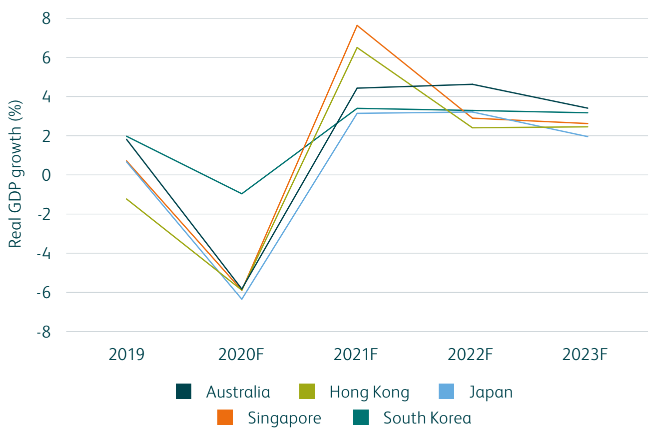


This page and front cover: Centropolis, South Korea.

COVID-19 has accelerated structural trends

The APAC region was the first to be affected by the COVID-19 outbreak at the start of 2020, highlighting the downside impact of the pandemic on economies, particularly tourism arrivals and manufacturing. With the outbreak having evolved into a global pandemic, a recession scenario appears likely for the five developed APAC economies this year. These markets, however, are expected to recover relatively quickly from 1H 2021 onwards (see Figure 1), benefitting from their relative preparedness in handling the pandemic and governments' strong fiscal and monetary support. This should help bolster investment sentiment in the APAC region.

Figure 1: Developed APAC economies are expected to recover relatively quickly



Source: Oxford Economics, May 2020.

The longer term impacts of this crisis are likely to be twofold: business vulnerabilities such as the lack of diversification in supply chains have been exposed, and structural changes have accelerated, for instance how people work, shop, eat and play. Looking past this pandemic, economic uncertainties are expected to prevail with trade and geopolitical conflicts between the US and China unlikely to be resolved quickly, and the tension between globalisation versus regionalisation also likely to weigh on businesses. As a result, businesses would need to increase operational resilience and flexibility while adapting quickly to economic digitalisation and shifts in geopolitics, as well as preferences of consumers and employees.

Investors should therefore leverage structural changes to future-proof their investment portfolios. Some of the key areas of opportunity include:

- Growing e-commerce penetration, expansion of supply chain capacities and automation are likely to drive tailwinds for the logistics sector in markets with a relatively bigger domestic consumer base
- Increasing economic digitalisation leading to wider adoption of omni-channel retailing and telecommuting is expected to fuel the 'hotelisation' of the retail and office sector. Assets which are more actively managed, provide flexibility and are of higher quality, in terms of both 'hardware' and 'software', are likely to be more attractive to occupiers
- Rising need for convenience, availability of amenities and employment are likely to continue driving demand for inner-city residential by millennials and Generation Z, thereby bolstering the sector's income resilience

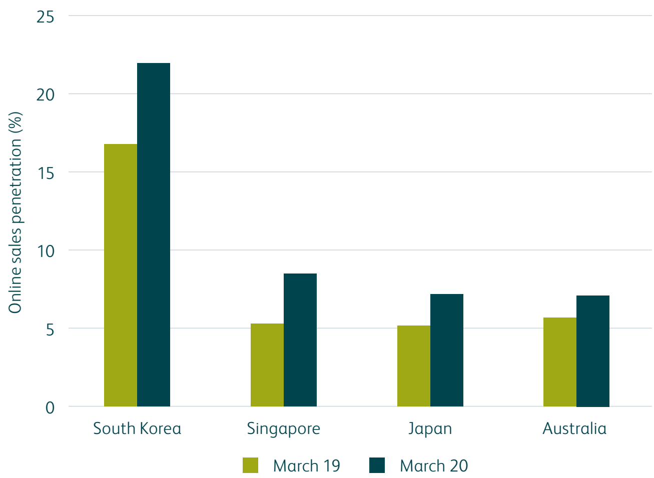
Business' requirements for enhanced operational resilience will drive tailwinds for logistics property

The logistics sector has shown resilience through the pandemic, backed by growth in e-commerce and rising demand for short-term leases as occupiers have sought more space, be it to stockpile essential goods or store inventories that had built up due to the lack of sales. This has led to stable occupancy rates in the developed APAC markets in 2020 thus far, and rising rents in markets with ultra-low vacancies such as Greater Tokyo.

The sector is likely to benefit from sustained tailwinds over the medium term, bolstered by both retailers' and manufacturers' need to enhance operational resilience post COVID-19. The pandemic has accelerated e-commerce penetration (see Figure 2) in all consumer segments and has compelled more retailers to implement omni-channel strategies to increase business resilience and strengthen sales networks. Similarly, the pandemic has also exposed existing operations and supply chain vulnerabilities among manufacturers. Consequently, more businesses in Australia, Japan and South Korea have started exploring the potential reshoring of manufacturing and/or reassessing storage requirements of key inputs. These would provide a further boost to demand in their respective domestic logistics markets. Upgrading demand is also likely, as more occupiers turn to physical automation to reduce reliance on labour and increase scale of output.

As such, markets with a relatively large domestic population in the APAC region, coupled with low availability of prime modern logistics assets, such as Tokyo, Osaka, Sydney, Melbourne and Seoul, should benefit from both increased e-commerce penetration and strategies employed by businesses to enhance operational resilience. Location, size and asset quality will continue to be key considerations; high quality assets with close proximity to key transport hubs, ports and consumers that can accommodate physical automation equipment are likely to command higher rents and prices.

Figure 2: The pandemic has accelerated e-commerce penetration



Source: M&G Real Estate estimates, May 2020.

Accelerated structural changes reinforce the need for active asset management of retail assets

The retail sector has felt the greatest impact of COVID-19 due to strict travel restrictions, social distancing measures and closure or reduced trading hours of non-essential retail businesses across markets. The pandemic pushed retailers into a 'fight or flight' response and accelerated industry consolidation at a time when the sector is already challenged by structural changes. Surviving retailers are likely to have adopted digital strategies, such as omni-channelling, successfully, and are expected to re-examine existing business and market practices, including real estate space. Retailers may place further emphasis on the quality, lease and asset management of retail assets as well as the type, in terms of targeted consumers.

The contrast between an actively-managed retail asset that has adapted to an omni-channel environment and one that has not, is expected to be more stark post COVID-19. Retailers are likely to call for more variable metrics such as footfall and digital-based value-add services by landlords to be factored into rental structures as the boundaries between digital and physical retail further weaken. Since the pandemic, some landlords have also adapted by introducing e-commerce platforms for their assets – an initiative that would allow retailers to expand their sales network. Consequently, retail landlords that can cater to their occupiers' evolving needs quickly are likely to be more successful at retaining and attracting retailers.

Retailers are also expected to place more emphasis on how diversified a retail asset's target consumer base is, to reduce high dependency on any particular segment such as tourists or transient catchments. Suburban shopping centres in dense neighbourhoods such as in Singapore, Australia and Hong Kong may appear more attractive as a result. High street retail areas that are largely dependent on tourist arrivals and the sale of discretionary goods, such as Tokyo's Ginza district, Osaka's Shinsaibashi, and Seoul's Myeongdong, are likely to see rental corrections over the next 12-24 months.

Occupiers' focus on quality will bolster the prime office segment

In contrast to the Global Financial Crisis (GFC) of 2008, office demand is expected to remain more resilient. Office employment for the prime office markets across most developed APAC markets should remain secure through this pandemic, particularly in key industries such as finance, business services and ICT. In addition, vacancy rates in markets such as Tokyo, Osaka, and Seoul GBD are at record low levels. Still, some markets are expected to record rental declines through the next 12 to 18 months, including Sydney, Melbourne, Hong Kong, and Singapore due to supply-side pressures.

The pandemic has provided businesses the opportunity to test telecommuting among its workers on a wide and prolonged scale. Consequently, corporates can better assess the proportion of employees that could work remotely on both an ad-hoc basis and for a sustained period of time. Allowing employees to work remotely would also help companies with their business contingency planning, and help integrate flexible working arrangements to promote employee wellbeing. All in all, increased telecommuting is expected to provide corporates more options to optimise space usage, primarily in terms of size and location, that best suit their needs and budget post COVID-19.

This has resulted in increased discussion over the future of the office sector, mainly centred around the potential role of the office and how occupiers may assess space requirements. While it is still too soon to draw a firm conclusion about how much office demand would change as a consequence of increased flexibility in working, offices are not expected to become obsolete given that they remain an integral platform for employees to collaborate, exchange knowledge and develop trust, within a secure space. These factors help an organisation spur innovation that is vital for growth – even more so in a period when most industries are facing digital disruption and more knowledge work is required.

Furthermore, in the developed Asian economies such as Japan and Hong Kong, high urban density in cities has resulted in more compact residential space for multi-generational families. In Tokyo, for instance, the average space of all homes is 65.9 square metres and around 20% of the city's 6.8 million households live in homes less of than 20 square metres[1]. This makes it difficult for many to work from home productively or in a conducive environment relative to an office environment.

Corporates, however, are likely to be more selective on the quality and location of their offices. In the interest of wellbeing, there will be increased emphasis on wellness, quality of building specifications, such as heating, ventilation, and air conditioning (HVAC) systems, and building management services, post COVID-19. Location is also expected to remain key for economies of agglomeration, high transport connectivity, and to attract talent. Consequently, centralised sub-markets with a higher proportion of Grade A, premium developments are likely to remain more resilient.

Preference for inner-city living is set to continue

Japan's multi-family residential sector has remained resilient with stable occupancy rates and positive rental growth observed since the outbreak of COVID-19. As white-collared employment continues to be healthy, occupancy is unlikely to decline significantly. This sector has also shown strong income stability through past economic downturns such as the GFC (see Figure 3).

Figure 3: Japan's multi-family housing sector has shown strong historic income stability

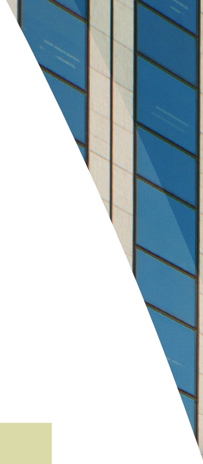
Source: MSCI, May 2020.

The preference for inner-city living in Japan should remain undeterred in the longer term. While there is speculation that the trend of city living could reverse post COVID-19, driven by fears of living in a highly dense environment, studies[2] have shown that density does not appear to be a major contributor to the rapid spread of COVID-19. Therefore, the benefits of living in cities continue to prevail. For instance, cities provide businesses the scale and density to operate and provide services such as retail delivery affordably. This gives city dwellers convenience and access to a wider range of amenities. In Japan, where natural disasters such as earthquakes and typhoons are common, better infrastructure in cities is deemed to be safer for residents. White-collared job opportunities will also likely remain centred in cities such as Greater Tokyo and Osaka, making these locations attractive to millennials and Generation-Z.

The sector could experience some structural shifts on the back of a potential increase in telecommuting. Larger units could face higher demand, as opposed to compact units that are typically less than 45 sqm in size, as more space is needed to make telecommuting more conducive, particularly with the rise of dual-income households. Similarly, apartments that have been retrofitted with smart systems that monitor air quality, electric and water consumption could be more favoured as tenants place higher emphasis on health and wellness. As a result of the need for bigger units and upgraded facilities, tenants could shift to cheaper sub-markets within Greater Tokyo, such as Yokohama.

Through this pandemic episode, what is clear is that the low-capex requirements coupled with the non-discretionary nature of the Japanese residential sector underline its defensive nature through times of economic crises. Thus, well-located prime multi-family residential units in Greater Tokyo and Osaka should remain poised to deliver stable returns over the next 36 months.

[1] Housing and Land Survey 2018, Statistics of Japan.
[2] World Bank: Urban Density Is not the Enemy In the Coronavirus Fight: Evidence From China, April 2020.



Medium-term investment strategy recommendations:

Sector	Structural shifts likely to be reinforced by COVID-19	Investment/asset management strategy
Logistics	• Increased e-commerce activity • Additional capacities built in supply chains for more operational resilience • More automation and implementation of technology in logistics process	• Well-located assets close to strategic transport networks and households as occupiers seek to minimise transport time and costs • Suitable building specifications and size that allow occupiers to install robotics and technology-enabled solutions
Retail	• Increased omni-channelling and implementation of digital strategies by retailers • Amplified need for social interaction, sense of community and convenient shopping	• Suburban shopping centres in dense residential neighbourhoods • Tenant mix to comprise anchor supermarket and essential services • Introduction of leases with more variable metrics including footfall, digital-based value add services such as landlords' e-commerce platform for occupiers or digital marketing initiatives
Office	• Rise in telecommuting among corporate employees • More emphasis on employees' health and wellbeing • More need for flexible space for business continuity planning or to handle ad-hoc increases in employees working from the office • Increased digitalisation	• Higher quality developments with 'green' certification which is also in line with growing demand for 'ESG-compliant' investments • Move towards 'real estate as a service' model by providing solutions for occupiers such as introducing flexible space within assets for occupiers to expand and shrink space quickly
Residential	• Stronger demand for inner-city living to reduce commute times, have better access to amenities and for convenience • Growing need for digital solutions to facilitate more healthy and convenient living	• Location remains key • 'Smart' apartments that allow tenants to 1) monitor air quality, electric and water consumption on demand; 2) have remote access for parcel delivery or house cleaning services; 3) have digital concierge services, may be more attractive

Centropolis, South Korea.

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