The Investment Podcast

M&G Investments

Episode 13: The Investment Podcast: Taking Asian real estate assets to another level in 2022
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Romil Patel: Hello and welcome to this instalment of *The Investment Podcast*, brought to you by M&G Investments. Today's theme is real estate, a sector, which like every other has indelibly been reshaped by the pandemic. In addition to dealing with known knowns, such as asset prices and responding to the inflationary environment, real estate investors must now also navigate emerging dynamics. This includes offices that cater to cultures and geographies, as well as applying the highest of sustainability standards to buildings, which account for 40% of global carbon emissions.

I'm your host, Romil Patel, and I'm joined by M&G's Jose Pellicer, head of investment strategy in the real estate division, and Richard van den Berg, manager of the Asian property core strategy. Welcome to you both.

Jose Pellicer: Glad to be here.

Richard van den Berg: Good to be here, Romil.

Romil: Thank you. Richard, you sit in Asia. As a European, how do you approach doing business in Japan and Korea?

Richard: There's a lot of myths about doing business in Asia being completely different, and I think it applies to any country where you do business, which is not your home business, and that is that you need to have local people on the ground. You need to have local people to do the negotiations, you need to have people to do the asset management, and you need to be sensitive for changes and differences in culture.

That applies very much to Asia as it does to any other part of the world where you're outside of your home territory. If you look, for instance, at North Asia and you go from China to Japan – China, Korea, Japan – you see very different ways in which the culture integrates with businesses. In Japan, it is very much a bureaucratic process. It's a very streamlined and organised process, it's very much a team process where everyone needs to be on board and where discussions take place as long as is needed to get a consensus.

If you then hold it against China, it is almost completely the opposite. The process is very fast, there's a strong leadership whose opinion basically determines what is going to happen, and Korea is a little bit in the middle of that.

Jose: I totally agree with Richard, it's very important to have feet on the ground. This can be done, and this happens everywhere in the world, but either you have employees in the local country who can help you, but you can also work with operating partners. Obviously, employees are better, but many managers also use operating partners. We effectively use a mixture of both, depending on the transaction.

Romil: Indeed. We've seen China take measures to safeguard its economy by ensuring that debt is at more appropriate levels. How does this apply to real estate and indeed the construction sector?

Richard: Real estate is important in China. About a third, depending on how you calculate it, but about a third of the GDP is in one way or the other linked to real estate developments and investments, and therefore, debt levels in one-third of the economy clearly play an important role in the way the central government looks at their exposures. Over the years, specifically on the real estate side, you see that companies have been not just been focused on purely real estate but also taken on a lot of additional business sectors, in particular, finance.

Real estate companies have taken stakes in banks, set up banks, real estate companies have set up financial investment products. Therefore, the line between finance and real estate has been blurred and has often been able to escape government regulatory oversight. Debt levels there have increased substantially, in particular, with regards to local banks and some of the very large real estate companies and, with that, have become a risk to the economy as a whole.

Therefore, the Chinese government has set up the famous three red lines in which they try to manage the exposure of these companies to debt and to financial products. It very much is a way of ensuring that excesses and domino effects will not take place than it is already taking place at this moment.

Jose: As a Spaniard, actually, I see many similarities between China today and Spain back in the mid to late-2000s. Construction was the key driver of the economy. Local banks were the key lenders of this big construction expansion, and local politicians were involved with local banks, and as we know, it all ended up in the global financial crisis and the euro crisis, but there is one key difference, which is that Spain had its hands tied. Spain was part of the euro.

It couldn't devalue its currency and inflate its way away from that, and the European Central Bank didn't start quantitative leasing until much later. I think that China has the tools to manage this crisis in a far smoother way than Spain had it at the time. China has insane amount of foreign currency reserves, and it controls its currency. It's not just even though construction is 30% of the economy, the wider defined construction, China is also at the forefront of technology, is a big exporter, so it's got many, many things to its advantage.

Richard: Yes, and it doesn't mean there are no risks, right? A country and an economy the size of China and the speed in which the economy and the society has changed over the last 30 years is clearly phenomenal and poses some risks on stress levels. That clearly is the case, but on the other hand, if you look at the economic growth, still 4% to 5% and you might say, "10 years ago, it was 10%." That's absolutely true, but since then, the economy has more than tripled in size, and in dollar terms, growth is still extremely large.

Jose: Exactly. What I was going to say – sorry to interrupt you – is that when you're growing at 10% but your economy is three times smaller, the amount of dollars is pretty much the same. Right now, the amount of dollars that are added to the world economy are basically the same as they were when China was growing at 10%, so it's very, very, very sizeable.

Richard: With that also, China's middle class now is the largest in the world. It's a relatively wealthy middle class. The consumption patterns have been going up. The economy is a lot more diversified than it used to be where it was in the old days, very much focused on manufacturing and exports. Now there's a lot of technology, research, consumption, as I just mentioned, added to it.

Clearly, it still is very much expert-oriented. In that expert orientation, also the diversification has taken place where it's not just only to the US and Europe but also to other parts of the world – to Africa, South America, and clearly, Asia as well. It's much more diverse. It has strong currency reserves, it also still has a reserve ratio of banks, which is relatively high and recently has been brought down a little bit to pump more money into the economy. There are a lot of areas where the government has tools to ensure that this transition, which is taking place, is taking place in a balanced way.

Romil: Let's turn to the issue of pricing, which is steep compared to historical levels, but we're living in a period where all pricing is steep. What should a core manager be doing under these circumstances?

Richard: Yes. Look, pricing is steep, but let's say it is high if you purely look at absolute numbers, at cost per square foot or square metre, and you look historically back, but if you take different metrics and you compare pricing and the premium of yields above the, let's say the benchmark, the 10-year government bond rate, then, in fact, that premium is still historically on the upper edges, and that means that there is a buffer in case interest rates go up to still absorb those without having immediate effect on real estate pricing.

Yes, it is high but not necessarily over-expensive because the premium over a bond rate is still pretty strong, so it's difficult to see how, in the short-term, there would be strong price corrections just based on the high historical pricing.

Jose: Yes. Also from a strategic perspective, in a period where pricing is rising, it is important strategically that whenever, if there are risks in terms of further variants of the Covid virus or potentially inflation is to focus on quality because it is quality assets that will be in demand from tenants and where you can create some tenant tension to achieve rental growth.

In other words, if you have an empty floor in an office building that is one of the best in the city and there are three tenants that want it, that's where you can start charging higher rents. That strategy of upping the quality of a core portfolio, I think, is particularly important in periods like today, where pricing is rising, and there are some economic risks.

Richard: Yes. I completely agree with you. If you look at curves in, let's say, the real estate markets, then we are at the upper end of the curve, and although I don't see an immediate correction, the downside risk is much higher than the upside potential with regards to increases in value and therefore, you need to structure your portfolio.

You are able to absorb any kind of shock should that happen on that downside, and what you're saying is the correct way, you want to take risk out of the portfolio.

How do you do that? You upgrade the quality of the assets you have, make sure that your tenants have a higher credit, lower-risk tenants. You bring your debt levels to a lower level, make sure that your covenants have strong buffers in them. In a way, you make your portfolio more shockproof at the higher end of the curve than when you would be at the bottom end.

Romil: Speaking of shocks, Richard, we've seen office requirements shift significantly as a result of the pandemic. There are a number of factors at play, including culture, geography, and sustainability. How will offices accommodate all of these competing requirements?

Richard: Yes, I think first the jury is still out, there are a lot of different influences taking place in the office sector in Asia. Some of them are positive, some of them are negative, and how in the end it will result in demand is still a question, but overall, office use in Asia, in particular, is quite different from in, say, Europe, the States, or even Australia.

The kind of willingness, interest of people to go to the office, the need of people to go to the office is much more than in other parts of the world.

It's a combination of very physical rational dynamics where people live smaller sometimes with multiple generations in their home, husband and wife working, where you just can't work from your home in an undisturbed manner, as well as some cultural aspects where you want to be in the office, you want to be seen to be working, you want to be part of a team. I just mentioned in Japan, the kind of team spirit and the team decision-making are very important.

You want to do that around the table and looking at each other. From that perspective, we don't see a reduction in demands related to the usage. In Asia, we still also have economies, which are growing and growing fast, or at least relatively fast, and that means with a growing economy it's clearly a direct relationship to increasing demand in office space.

Australia is probably a little bit more in line with Europe and the States where working from home is much more accepted and much more already part of the way the people work, but there you're seeing that a lot of companies, larger companies, in particular, are focusing the use of office and their office location to be as central as possible with amenities around it in the middle of infrastructure nodes, where people from all parts of the city can get easy access to. There we see an increase in demand for really high-quality, new, modern ESG, well-designed office space, while the more fringe locations are seeing a reduction in demand.

Jose: There is that point that as the population gets more spread, the commutes become more, let's call it challenging. The more challenging a commute is, the more propensity there is to work from home, everything else constant. Indeed, Richard's totally right, it depends on the size of the dwellings. In Australia, they happen to be bigger.

Having good ESG credentials in your building, in a good location where it is hard to build, you've got yourself an important asset, an asset that should be fit for the next 30 years. That is what, as a real estate investor, we really need to aspire to: a location that is a monopoly over a piece of land and that has the right ESG credentials of energy consumption, water consumption, greenhouse gas emissions, etc. and that tenants want to be in, even in countries with more propensity to work from home like Australia. A good building in the centre of Sydney is a brilliant piece of real estate.

Richard: In that, you're also seeing changes in the relationship between landlord and tenant, where now it is much more a concerted process. In fact, we see ourselves very much as a service provider to tenants, what are their needs? How are their needs changing? How can we accommodate that? What amenities do they need? What kind of ESG, facilities and requirements do they have, and how can we fulfil that? It's very much working with them as a service provider than purely as a space provider.

Romil: Before we go, let's consider residential property in the Asian market. Richard, what is it about the current state of the market that potentially makes it attractive for investors?

Richard: Look, I think residential prices, and this is, globally, the case, residential prices everywhere have risen very, very high over the last five to 10 years. To an extent, in many countries and, in particular, in Asia where pricing already was high, residential space for the younger generations, the people who have left university, let's say age group between 25 to 35, 40, price levels have risen to a height where it has become very difficult for them to get an entry into the market.

That's where the traditional objectives of owning an apartment or a house as soon as you could and climbing up that real estate ladder now has become virtually impossible. Also together with a changing, I would say, almost cultural need to not own but lease, a whole new generation has come looking at renting and not at buying. That is something, which is slowly emerging throughout Asia Pacific, so in Australia and to a certain extent, Hong Kong, and maybe later in Korea.

Now, for a long time, those rental sectors of the residential market have been dominated by private ownership and, to a certain extent, have been quite immature and primitive in the way leasing deposits would be structured. You can see now that more institutional investors and developers are moving into that sector and where the so-called, in Australia, built-to-rent developments are starting to emerge and built-to-rent for institutional investors for a long-term hold.

We believe that that trend is going to continue and, in fact, will gain a lot of momentum. Australia is on the forefront of it. Japan already is mature, and we think more too long in the future, Korea and Hong Kong may follow.

Romil: Well, that's all we have time for it in today's episode of *The Investment Podcast*. Thanks indeed to Jose Pellicer and Richard van den Berg for sharing their expertise and to you for tuning in. Please join us next time. Goodbye for now.

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Speaker: This podcast is for investment professionals only. For further information, please view the notes which accompany this episode.

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