Executive summary

- Backed by synchronised global growth prospects, continued improvements to business and consumer sentiment expected
- Singapore office rental growth is likely to be strongest, with improving supply and demand dynamics
- Preference for logistics and South Korean logistics may see relatively higher total returns
- Geopolitical risks for APAC stem from inside and outside the region

4.8% y-o-y APAC 2018 growth
6% p.a. rental growth in Singapore offices over the next three years
8% p.a. total returns in Seoul logistics between 2018-22
Synchronised global growth is positive for Asia Pacific economies

In 2018, the regional output from Asia Pacific (APAC) should follow a similar pace of growth at 4.8% y-o-y, versus the expected growth from Europe at 1.9% y-o-y and from the US at 2.5% y-o-y.\(^1\)

Synchronised global growth (a first since 2010) should bode well for global trade flows, and set the stage for further improvements to business sentiment in this export-led region. Coupled with Asian companies moving towards more advanced manufacturing and increased intra-regional trade flows to service the increasingly wealthy regional population, these provide favourable tailwinds for growth.

With China expected to grow around 6.5% in 2018, the relatively strong growth of this US$12 trillion economy is likely to support export growth for many of the regional economies. Looking across the developed economies, South Korea is expected to lead regional output growth at 2.9% y-o-y in 2018, followed closely by Australia (2.8%) and Hong Kong (2.5%). Whilst Singapore’s manufacturing sector has benefitted from the global trade recovery in 2017, the relatively soft labour market may weigh on its overall growth. President Abe’s recent re-election indicates that Japan’s economy is likely to continue with a stable growth of 1.2% in 2018.

As highlighted earlier in the year, the gradual economic recovery should motivate select regional central banks to start raising interest rates. The Bank of Korea, with a more hawkish stance, was the first to do so in the region recently with its first rate hike in six years, as its policy rate was raised by 25 bps to 1.5 per cent.

While interest rates have already started to rise, some regional central banks are still likely to remain cautious in raising policy rates or withdrawing stimulus too quickly. Japan, for example, remains committed to its zero interest rate policy (“ZIRP”) in its continued effort to revive the domestic economy.

Geopolitical risks are expected to persist in 2018, as media headlines on the Korean peninsula tensions and the possibility of a US-China trade war could continue to worry businesses and investors. With China now more committed to making a stronger push for economic reform, it may lead to increased financial sector supervision and a pullback in excessive credit expansion. Outside of Asia Pacific, uncertainty over possible US policy errors and Brexit negotiations could represent key external risks for the region.

**Figure 1: Global GDP forecast by region: 2017-2019(f)**

Source: Bloomberg consensus economics estimates, as of December 2017.

**Figure 2: Key risks and impact assessment for Asia Pacific**

Source: M&G Real Estate, as of October 2017.

---

\(^1\) Bloomberg consensus economic forecasts, as of December 2017.

\(^2\) The Bank of Korea, 30 November 2017.
Asia Pacific Property Markets

**Office**
Singapore rental growth likely to see the strongest overall growth over the next three years, driven by a medium-term grade A supply drought. Sydney and Melbourne will continue to see relatively robust rental growth over the short-to-medium term.

**Retail**
Recovery in consumer sentiment and continued growth in regional tourism should lift rents for the region, particular for Hong Kong. In Singapore, there may be a surprise on the upside to retail sales due to wealthier consumers.

**Logistics**
Demand stemming from continued e-commerce growth and improved retailer omni-channel strategy should drive healthy demand for logistic warehousing and support stable rental growth.

**Property yields**
Cap rate compression is expected to make up less of the total return regionally and globally, so investors should pay close attention to relative yield buffers, or risk premiums, as interest rates start to rise.

Supply demand dynamics positive for near-term office rental growth

The uplift in business sentiment, coupled with the stronger economic growth expected in 2018, should support healthy occupier demand for the regional office markets.

Singapore is expected to outperform the regional office market in terms of rental growth over the next five years, as the expected quantum of new Grade A office supply is likely to be negligible over the medium term. In the face of relatively healthy occupier demand, particularly from Asian financial institutions and the tech, media and co-working sectors, office rents should see upwards movement of around 5% to 6% per annum between 2018 and 2020.

Similarly, the limited office supply over the next two to three years in the Australian cities of Sydney and Melbourne should support relatively robust rental growth over next 18 to 24 months. Towards the tail-end of the next five years, however, both cities may see downward rental adjustments due to upcoming new supply providing occupiers with more options and negotiating leverage. With Brisbane’s office market expected to see incentive levels - discounts provided by landlords - steadily decline, net effective rental growth should average around 2% to 3% per annum over the next five years to 2022. Whilst the pace of the office market recovery in Perth is relatively more difficult to gauge, the expected decline in vacancy rates should improve incentive levels to below 50% over the medium term.

Supported by the steady expansion of Chinese firms setting up new offices or expanding their existing presence in Hong Kong, occupier demand for Grade A office space, particularly around Central, should continue to drive rents higher, albeit at a more moderate pace. Despite higher level of upcoming supply expected to come to market over the next five years, none of the new supply will be in Central, and little of it will be on Hong Kong Island. As such, rental growth is likely to be bifurcated, with modest growth in more central districts and zero-to-slightly-negative growth in decentralised locations.

Likewise the Seoul office market should remain relatively polarised between the slowly recovering CBD and the already strengthening Gangnam (GBD) submarket. The key reason behind the contrast is due to the stronger growth and expansion appetite of tech-related occupiers within the GBD versus the more cautious blue-chip firms residing within the CBD. However, with the strong pick-up in South Korea’s economy, there may be more appetite in the CBD for expansion, or upgrade relocation, over the next one to two years.

In Japan, the Tokyo Grade A office market is expected to see around 2% growth over the next couple of years before a wave of new supply starts to drive up availability and shift the balance in favour of tenants. For the moment, the office market vacancy remains at extreme-low levels of below 2%. In the regional city of Osaka, rental growth should continue to be relatively strong due to the lack of new supply and the sub-3% vacancy rate.

![Figure 3: Asia Pacific office vacancy rates](source: M&G Real Estate based on PMA data, as of October 2017)
Not all doom and gloom for retail

With the pace of e-commerce growth expected to slow over the next five years to single digits by 2020-21 for the developed markets in Asia Pacific, the disruption experienced by retail may begin to ease over the medium term. Retailers are also coming to grips with the evolution of retail by focusing more attention towards becoming omni-channel.

As stated in the latest PwC survey in 2017, less than a third of retailers have implemented strategies that provide a single view of the consumer. This may mean more potential upside for stores, as more retailers implement more engaging consumer strategies to improve both online and offline sales.

Looking across the developed markets in Asia Pacific, improvements in consumer sentiment and continued growth in regional tourism should have positive implications for the gateway cities. Hong Kong is expected to see relatively stronger rental growth of around 3.2% per annum over the next three to five years, as retail rents start to recover following the steep decline over the past two years.

Similarly, Singapore retail rents should start to rise by around 1.5% per annum, as both tourism spending and domestic consumer sentiment improves in 2018. In addition, the positive effects of residential en bloc sales may boost further consumer spending, as sellers cash-out and redeploy this money elsewhere. Although a potential Goods and Services Tax hike in 2018 or 2019 could restrain spending initially, as consumers adjust to the new level (9% estimated by analysts).

With relatively stronger population growth, Australia’s retail market should continue to be supported by growth in aggregate consumer spending. In Sydney and Melbourne, retail rents are expected to grow between 2% and 3% over the five-year forecast period to end-2022.

Figure 4: Growth in store-based sales to be led by Australia, Hong Kong and South Korea

Structural uplift for logistics warehousing to continue

Whilst online retailing growth is expected to slow in most of the five developed Asia Pacific markets by 2020-21, the organic growth from e-commerce coupled with retailers expanding their omni-channel efforts are supportive of continued demand for logistics warehousing in the region.

That said, there may be some markets that need time to work through existing or new logistics supply where completion levels are high, such as Singapore and Osaka. The outer area surrounding Tokyo may also see rental growth slightly dampened by higher levels of speculative supply, but the occupier take-up has remained strong. With the entrance of Amazon into Australia in late-2017, there should be increased demand for logistics warehousing space over the medium term. It is also important to note that older warehousing stock that is in more strategic locations may see heightened demand, as last-mile delivery demand steadily increases. Overall, logistics rents should see relatively steadier rental growth that is in line with inflation at least, while better-located assets are likely to see stronger rental growth.

Figure 5: Asia Pacific total returns for logistics sector 2016-2022(f)

Source: M&G Real Estate, as of November 2017.

Source: Euromonitor, as of December 2017.

---

1 M&G Real Estate based on data from Euromonitor as of December 2017.
2 PwC “Total Retail 2017”.
Evaluating the overall rental growth profiles for APAC, Sydney and Osaka office markets are expected to outperform the region over the next two years (2018-19), while Singapore industrial rental growth may remain negative through 2018.

In 2019, both the Singapore and Osaka office markets are likely to see strong rental growth due to the lack of Grade A office supply. Looking further ahead, the downward pressure from new completions offering occupiers more space options is likely to drag down rental growth in Melbourne, Tokyo and Sydney over 2020.

With recent transaction volume still hovering between the relatively higher five-year average and the ten-year long-term average, commercial real estate liquidity remains elevated.

Investors’ growing appetite for commercial real estate in Asia Pacific, whether to increase allocation to the region or for diversification purposes, should continue to support transaction volumes around the current levels.

While cap rates have tracked lower over 2017 and are expected to rise as interest rates increase over time, healthy property yield spreads and rental growth should provide a sufficient buffer against the expected mild expansion in cap rates. Over the short term, the momentum provided by strong investment appetite for commercial real estate may continue to push relative higher yields lower for select markets and sectors, such as in Australia and logistics.
Total return may be relatively muted due to less cap rate compression

In 2018, total returns may look relatively muted in comparison to the recent three years of strong capital value growth due to steep cap rate compression. While Asia Pacific is expected to deliver a total return of around 6% p.a. over the next three years on average, the portion of returns from capital value is expected to contribute less than a third of that.

Due to its relatively higher yield, Australia may see continued inflows of capital pushing cap rates slightly lower over 2018. Short-term rental growth should continue to provide uplifts to valuations, as market fundamentals continue to improve in Sydney and Melbourne. Brisbane’s office market recovery and relative pricing should continue to attract investor focus over the short to medium term.

In terms of sectors, total returns for the industrial sector looks most attractive at around 7% p.a. over the next three years, with markets such as Australia and South Korea looking relatively more attractive. Coupled with mild cap rate compression and the relatively higher yields of 5.5% to 6.0% in these two markets, the expected total returns may range around 8% to 9%. The office and retail sectors are expected to provide total returns ranging between 5.5% and 6% p.a. over the same period.

With specialty sectors gaining more traction in the region, select segments such as student housing, self-storage and hotels may provide attractive returns. However, adequate risk premium or mitigation plans must be in place to counter the relative lower liquidity and heightened operational risk of these specialised assets.

Figure 8: Asia Pacific sector total return expectations, 2018-2020(f)

Source: M&G Real Estate, as of November 2017.