QUARTERLY INSIGHTS | INVESTMENT RESEARCH

ASIA PACIFIC

Key Themes

- What Will a China Reopening Mean for APAC's Real Estate Markets?
- Will Rent Reversion Help Support Logistics Values?

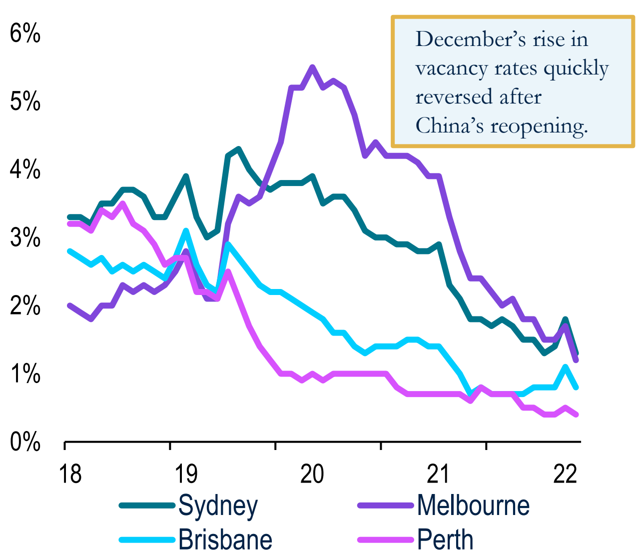
What Will a China Reopening Mean for APAC's Real Estate Markets?

China's reopening will be positive for APAC economies and real estate markets, although the impacts will be uneven across countries and sectors depending on levels of exposure to China. There are several markets that will particularly benefit from the border reopening.

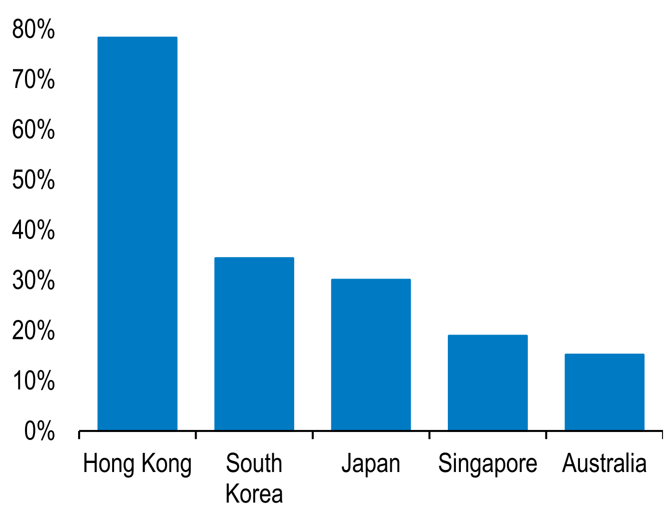
With nearly a third of enrolled students coming from overseas – of which Chinese students accounted for the largest proportion in 2019 – Australia's purpose-built student accommodation (PBSA) and the residential market will be among the top beneficiaries of returning Chinese students, with nearly 50,000 students expected to re-enter Australia in the coming months[1].

Exhibit 1: Australia and Hong Kong Set to Benefit from China's Reopening

Australia Residential Vacancy Rates (%)



Share of Mainland China Tourists (% of Total Tourist Arrivals) in 2019



Note: Hong Kong data is an average of 2018 and 2019 to balance the impact of social unrest in 2019.

Sources: SQM Research, CEIC, PGIM Real Estate. As of February 2023.

[1] PMA.

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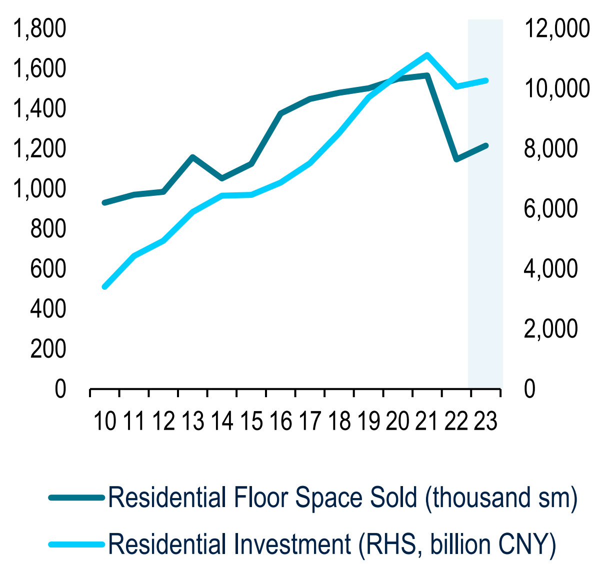
The return of Chinese international students will support the already tight PBSA sector. The Property Council of Australia revealed that PBSA facilities in many cities are at capacity, with almost no vacancy expected throughout 2023. Besides PBSA, the rental housing market will also benefit from the knock-on effects of the tight student accommodation market as students look for alternative accommodations. Statistics show that residential vacancy rates in Sydney declined 50 basis points to 1.3% in January this year, just shy of a record low of 1.0%, while it fell the same amount to a historically low level of 1.2% in Melbourne (**Exhibit 1**, left chart). Rental growth prospects for both sectors are clearly boosted by strong inflows of students from China after the reopening.

Another market that is expected to benefit from China's border reopening is Hong Kong. Having a tourism sector with large exposure to China (**Exhibit 1**, right chart), Hong Kong is set to benefit from a surge of travelers from mainland China. Sectors linked to tourist arrivals and spending, like hotels or high street retails, are expected to experience the most significant shift in near-term outlook, with real estate brokers such as JLL upgrading their forecasts expecting a more momentous recovery in the next 12 months.

But the market expecting the most fundamental shifts in investor sentiment and expectation is China itself. China's residential sector – which has been through a challenging time over the past two years – shows signs of stabilizing thanks to the combined impacts of reopening and easing of financial conditions. Several measures targeting to support the residential market, such as more favorable mortgage conditions for first-time buyers, lower interest rates and more flexible lending conditions for developers, have started to show their impacts. Monthly data in January report stabilized house prices in major cities and sales volumes beginning to pick up[2].

Exhibit 2: China Residential Property Markets are Expecting a Nascent Recovery in 2023

China Residential Investment (Billion CNY) and Floor Space Sold (Thousand sm)



Performance of MSCI China Real Estate Equity ETF and Premia China Real Estate Offshore USD Bond ETF (April 2021 = 100)

Sources: CEIC, Real Estate Foresight, Bloomberg, PGIM Real Estate. As of February 2023.

[2] Real Estate Foresight.

Forecasts for China's residential market have improved, with a recovery expected in 2023 compared to a forecast of prolonged L-shape before the reopening (**Exhibit 2**, left chart). Public markets have also showed an improved sentiment with both bond and equity real estate indexes rising c.190% and 65% from their November troughs, respectively (**Exhibit 2**, right chart).

In summary, China's decision to reopen its border and shifting financial policy to a more accommodative stand will have net positive impacts on China and several regional real estate market, particularly those expected to benefit from the return of Chinese tourists and travelers.

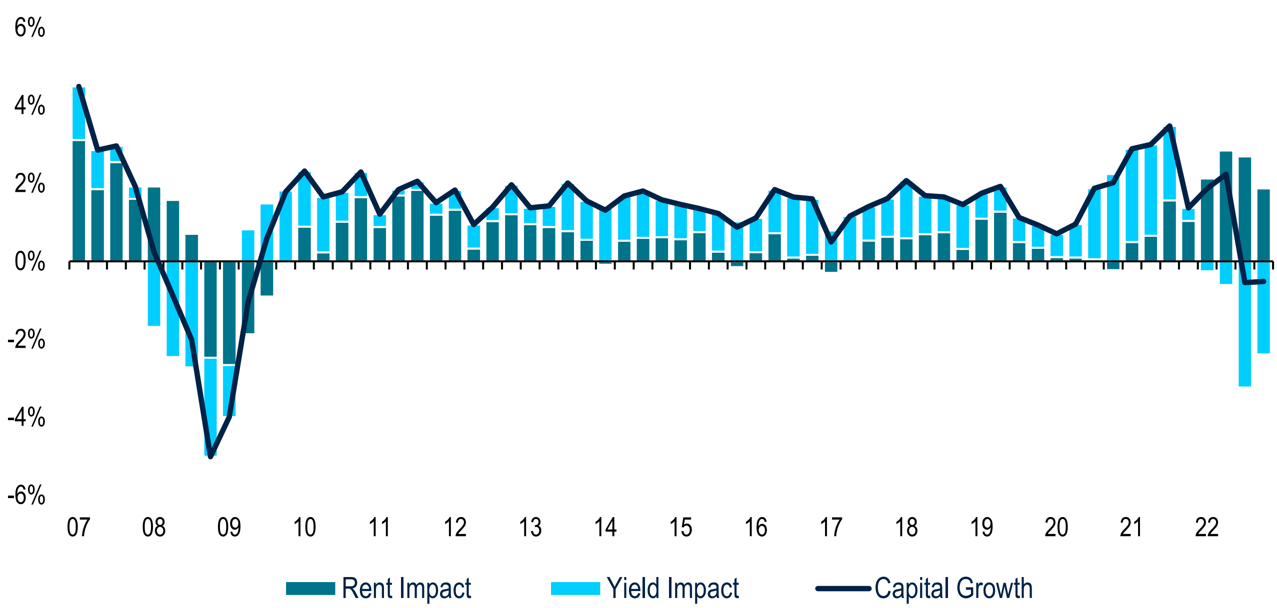
Will Rent Reversion Help Support Logistics Values?

After years of compression, logistics cap rates are under pressure to expand as central banks across the region continue to hike interest rates in the fight to control inflation. Pricing discovery started to take place in several markets, most notably in Australia and South Korea, with cap rates expanded in the past few quarters (**Exhibit 3**).

But capital values have been holding up relatively well thanks to stronger-than-expected rental growth (**Exhibit 3**). In 2022, Australian logistics markets in Sydney and Melbourne experienced record annual rental growth of over 20%. Similarly, Seoul saw nearly 10% rental growth. The overall logistics sector in Asia delivered over 5.2% real rental growth in 2022, despite the elevated inflation rates. Higher rents are helping logistics assets offset the negative impacts from yield expansion in these markets. As we expect pricing to continue recalibrating in the regional markets, with further expansion in logistics cap rates expected in 2023, rental growth remains critical to support asset values.

Exhibit 3: Rental Growth Has Been Crucial in Supporting Logistics Capital Values

APAC Logistics Sector Capital Growth (% p.a.)



Note: APAC logistics sector includes Australia, China, Hong Kong, Japan and South Korea.
Sources: JLL, PGIM Real Estate. As of February 2023.

However, with major economies in the region reopened fully and economic activities normalized, the pandemic-driven surge in logistics demand has slowed across key cities. Following aggressive expansion in the past 18 to 24 months fulfilling logistics demand of e-commerce players and related third-party logistics (3PLs), leasing activities moderated gradually. While high-quality logistics assets in desirable locations continue to record solid leasing performance, vacancy grew increasingly sticky in certain submarkets and the moderation of demand started to weigh on the rental growth outlook.

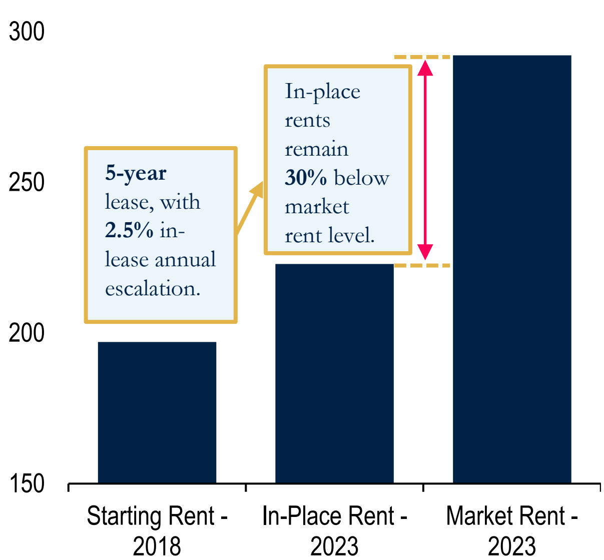
While headline rental growth is likely moderating, strong rental uplifts in the past two years have created a significant gap between in-place and market headline rents, implying rental reversions for assets having lease renewals coming. Taking the Sydney market as an example, in-place rents estimated for an asset with a 5-year lease started in 2018 and annual in-lease rental escalation of 2.5% would be approximately 30% below the nominal market rent level in 2023 (**Exhibit 4**, left chart).

Using the same methodology to assess potential rent reversions, we estimate that there is a broad-based presence of under-rented assets in several markets such as Sydney, Melbourne, Tokyo and Singapore (**Exhibit 4**, right chart). Estimated rental reversion averaging over 10% across the key cities in the next two years is well above the inflation rates forecast of 2.6% p.a.[3]. The rental reversion potentials, together with more modest but still solid rental growth prospects across major markets, are crucial cushions to support capital values against the risk of further cap rate expansion.

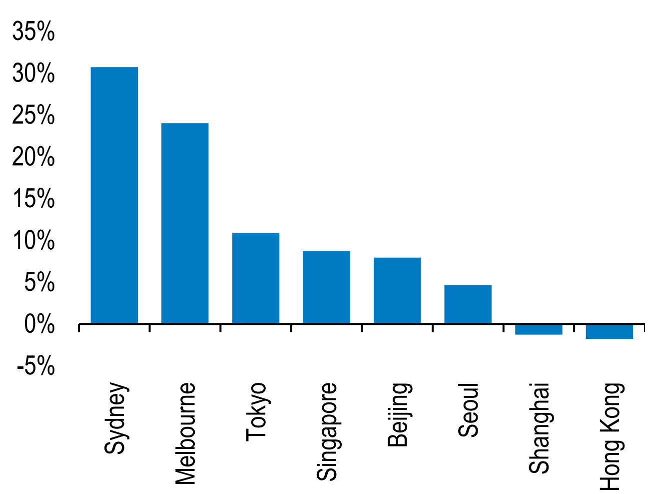
As such, while asset location remains critical for leasing performance as occupiers grow more selective, we expect that valuations of logistics assets in established submarkets with shorter weighted average lease expiry (WALE) – hence offering faster mark-to-market rental reversion – will be more resilient and present more attractive investment options to investors in the near term.

Exhibit 4: Logistics Rents Reached New Heights, Rental Reversion to Help Defend Capital Values

Sydney Mark-to-Market Rent Reversion (AUD psm p.a.)



Potential Logistics Rent Reversion by Market (2023-24 Average)



Note: Rent reversion calculated based on 5-year leases in single tenant assets, assuming annual rental escalations: 3% annual escalations in Beijing and Shanghai, 2.5% in Sydney and Melbourne, 2.0% in Hong Kong and Singapore, 1.5% in Seoul and 0% in Tokyo.

Sources: JLL, PGIM Real Estate. As of February 2023.

[3] Oxford Economics.

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