Apac real estate values emerge after 'the great reset'

By Benett Theseira

THE sharp rise in global interest rates that took hold in the second half of 2022 drove a "great reset" of real estate values, with mixed impact on investors and lenders.

However, with interest rates peaking and inflation starting to ease, we are beginning to see light at the end of the tunnel. The Asia-Pacific (Apac) real estate market is set to begin its recovery in 2024, driven by stabilised capital values and resilient income returns.

The structural growth in terms of demographics, digitalisation and decarbonisation are driving secular shifts in occupier demand across real estate sectors and geographies. From the cyclical perspective, some markets in Apac current offer interesting entry prices and rental growth prospects, as the current cycle and price discovery enter a stabilisation stage.

Furthermore, the ongoing shift from the more highly regulated traditional bank-led financing and towards private market funding is creating new opportunities for debt investors.

Despite headwinds for the office sector globally, the outlook for office space in Sydney, Seoul and Singapore (above) appear compelling, while caution is advised for Japan and China. PHOTO: BT FILE

Apac among the most resilient regions

The Apac region has been one of the most resilient globally thanks to the diversity of its markets. The markets in the region have corrected at different speeds, and this diversity offers exciting opportunities.

Looking ahead, rental growth will be a key driver for the recovery, with the days of compression in capitalisation rates well behind us. However, the recovery will be uneven with varying momentum across major geographies and sectors. Overall, global real estate values are projected to decline by approximately 30 per cent from peak to trough. Asia (ex-Japan) may see a relatively modest 10 to 20 per cent decline, while Europe could face falls closer to 40 per cent.

In the Apac ex-Japan markets, higher interest rates and expanding cap rates have weighed on asset pricing, particularly in Australia and South Korea. These markets are expected to start stabilising and improving in the coming 12 months.

In contrast, Japan's persistent low interest rates have supported real estate prices and compressed cap rates in the past two years. The healthy yield spread and market stability continue to make Japan an attractive investment destination. However, the expectation that borrowing costs will rise marginally is putting a dampener on the outlook for asset prices.

Apac's structural opportunities: three Ds

As the reset continues and markets remain uncertain, real estate investors need to focus on what they can control – income. Long-term structural trends such as demographics, digitalisation and decarbonisation are attractive themes driving occupier demand and rental growth across various sectors.

Demographics plays a crucial role, particularly in major cities such as Sydney, Melbourne, Singapore and Tokyo, where the growing urban population and high cost of home ownership offer attractive prospects in rental housing. Additionally, other living sectors such as student accommodation and senior housing sectors are also benefiting from these population trends.

The undersupply of institutional residential rental housing in Australia, Hong Kong and most major cities in the region, and delayed new supply due to higher construction costs support the fundamentals of this sector.

Digitalisation is fuelling demand for data centres and logistics. We are in the early stages of a generational structural growth opportunity for such centres. Advancements in generative artificial intelligence are accelerating demand for them. Rental prospects also remain robust against the favourable fundamentals of solid demand and limited supply.

Hyperscale data centres serving major cloud providers are expected to experience strong rental growth, especially in markets with limited power supply such as Tokyo, Seoul and Singapore, as well as major Australian cities.

While logistics remains a favourable investment theme, investors should focus on selective core sub-markets. Prime and centrally located logistics assets in submarkets such as Sydney, Melbourne, Tokyo, Singapore and Seoul are expected to outperform, driven by automation and increased productivity in the third-party logistics and delivery sectors.

Finally, the decarbonisation trend is driving the need for properties with strong ESG (environmental, social, governance) credentials. Investors must therefore carefully select assets with robust green rating credentials and focus on stable income strategies for Grade A properties.

However, there are also opportunities as well-located assets are at risk of becoming stranded due to weak ESG credentials. These can be purchased at depressed pricing; occupier demand and valuation could be restored and enhanced through thoughtful retrofitting and asset strategies.

While the current entry prices in most Apac markets are starting to look interesting for long-term investors, some cyclical opportunities are also emerging from the downturn. Despite headwinds for the office sector globally, the outlook for office space in Sydney, Seoul and Singapore appear compelling, while caution is advised for Japan and China. The tourism recovery will be positive for the hospitality sector and high street retail, particularly in Tokyo and Osaka.

Real estate debt: plugging the funding gap

Given market dislocation and the sharp rise in interest rates over the past 12 to 18 months, many institutional investors see an attractive entry point to diversify their portfolios – with real estate debt.

Debt typically outperforms during periods of uncertainty, and this especially rings true in the current environment. Tighter banking regulations and low leverage tend to provide attractive entry points, and interest rates and lending spreads have risen, boosting returns.

Apac remains well behind the US and Europe in the non-bank lending market, but recent developments to shore up lending standards is accelerating growth. Regulatory restrictions, which increase capital requirements on bank lending, will lead to increasing buffers. This suggests banks may take an even more cautious approach to commercial real estate lending. It opens the door for non-bank lenders to fund in-demand projects.

In the high-yield debt space, Australia presents more compelling opportunities as banks remain very competitive in most other developed Asian markets. Regulatory pressure on Australian banks to reduce real estate exposures, particularly for riskier assets and projects, and a widening of the capital pool available for real estate lending are assisting this trend.

Investors need to be very selective though, particularly in the office and residential developments, targeting higher quality assets and well managed projects that will likely remain attractive to tenants and buyers throughout this cycle.

Portfolio diversification

Private-market assets including real estate and private credit are growing in favour among wealthy investors who increasingly turn to alternative investments for portfolio diversification and better risk-adjusted returns.

This is especially so for sectors with enormous growth potential and high entry barriers such as data centres. Today, these opportunities can only be accessed via real estate investment trusts or dedicated private funds.

The "great reset" caused some short-term pain, but relief looks to be around the corner for long-term investors searching for an attractive entry point. With interest rates hike in the rear-view mirror, investing in line with the secular trends is a good starting point.

In addition, a well-diversified real estate portfolio across equity and debt will no doubt deliver a less volatile and better risk-adjusted outcome, as we navigate the ongoing market challenges and leverage the expected recovery.

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