ASIA PACIFIC REAL ESTATE: STILL GOOD VALUE IN A CHANGED WORLD

PART 1 - A COMPARISON OF PROPERTY YIELDS WITH OTHER ASSET CLASSES
This report, Part One of a two-part series, highlights the good value of Asia Pacific (APAC) real estate by comparing property yields with yields on government bonds and equities.

Two key factors are impacting the values of APAC investments in general. The first is the COVID-19 recession, which should ease from now on. The second is interest rates, which have fallen to record lows.

These factors have extended a long global bull market in government bonds. Among core APAC investment markets, government bond yields range from effectively zero for Japan at the low end, through 0.8%-0.9% for Australia, New Zealand and Singapore, to 2.8% for China at the high end.

Dividend yields on major equity markets are higher, ranging from around 1.9% for the US S&P 500 to an unusually high 4.9% for Singapore. However, dividend yields are at risk from the recession’s hit to profits.

In comparison, yields of 2.8%-5.8% for prime/Grade A office assets and of 3.5%-6.1% for logistics/industrial assets in core APAC investment markets look attractive. Rents are under pressure in various city office markets, and a few industrial/logistics centres. However, the pressure is lower than pressure on corporate profits in equity markets.

We will discuss rent growth prospects and our preferred property asset classes in greater detail in the forthcoming Part Two of this series.

¹ Special Administrative Region [of the People’s Republic of China]
ASIA PACIFIC: SNAPSHOT OF YIELDS ACROSS ASSET CLASSES

Sources: Colliers International, S&P Global Market Intelligence, Financial Times, Hang Seng Indexes for Hong Kong
INTRODUCTION: TIME TO LOOK FOR VALUE AMID SIGNS OF RECOVERY

This report is Part One of a two-part series which explains why we still see good value in Asia Pacific real estate. In Part One, we compare yields on property assets with yields on government bonds and equity markets. In Part Two, we will discuss rent growth prospects and our preferred property asset classes.

In our view, two key factors are impacting the values of APAC investment assets in general. The first is the recession caused by COVID-19. The second is record low interest rates—the result of a decade of loose monetary policy and recent emergency rate reductions.

Growth depressed but set to rebound

The global economic expansion that began in 2009 has decisively ended. The COVID-19 pandemic has triggered lockdowns of entire countries and sharply reduced growth expectations globally. Except for China, most Asia Pacific markets will record negative real GDP growth in 2020.

<table>
<thead>
<tr>
<th>Country</th>
<th>2019</th>
<th>2020F</th>
<th>2021F</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>6.1%</td>
<td>0.8%</td>
<td>8.5%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.7%</td>
<td>-6.0%</td>
<td>3.7%</td>
</tr>
<tr>
<td>South Korea</td>
<td>2.0%</td>
<td>-1.0%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Hong Kong SAR</td>
<td>-1.2%</td>
<td>-6.0%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.7%</td>
<td>-6.0%</td>
<td>7.8%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>2.7%</td>
<td>-0.6%</td>
<td>3.6%</td>
</tr>
<tr>
<td>India</td>
<td>5.3%</td>
<td>-3.0%</td>
<td>11.3%</td>
</tr>
<tr>
<td>Australia</td>
<td>1.8%</td>
<td>-5.0%</td>
<td>3.3%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>2.2%</td>
<td>-4.0%</td>
<td>6.5%</td>
</tr>
<tr>
<td>United States</td>
<td>2.3%</td>
<td>-6.1%</td>
<td>6.3%</td>
</tr>
</tbody>
</table>

Source: Oxford Economics (latest available estimates)

More positively, although uncertainty is high, the recovery that is already starting in China should spread gradually to the rest of the APAC region over H2 2020, with a sharp rebound in growth likely in 2021. Indeed, since China is now the world’s largest economy on a purchasing power parity basis (see Figure 2), China has the potential to pull not only the region but the world out of recession, as it did after the Global Financial Crisis (GFC) in 2008-2009.

Incipient recovery should not push up interest rates

There is another silver lining to the COVID-19 recession. Over the past year, APAC central banks have either held policy short-term interest rates at already low levels or reduced them further. Signs of incipient economic recovery are unlikely to reverse this trend; on the contrary, we expect interest rates to stay low for several years. This outcome is all the more probable following recent indications from the US Federal Reserve that it expects to hold US interest rates close to zero through to the end of 2022¹.

¹ See, e.g., article in Financial Times, “Jay Powell delivers dovish message to financial markets”, 11 June, 2020.
LOW INTEREST RATES SET TO PERSIST, UNDERPINNING ASSET VALUES

The recent actions of APAC central banks in reducing policy interest rates have lowered effective or market short-term interest rates to record low levels, in many cases in a range of 0-2%. Among the core investment property markets in APAC (China, Japan, Hong Kong SAR, Singapore, Australia), the effective short-term interest rate is highest in China, where it stands at about 2.3%.

It is useful to study real interest rates, i.e., rates adjusted for inflation, since there is some evidence that these are more important in driving economic activity. Real rates have been negative in Hong Kong and Japan for years, but are set for a near-term rise to positive territory due to the deflationary effects of the recession. The Reserve Bank of Australia has been cutting rates for two and a half years, but current negative real rates in this market may also turn positive as inflation drops. China should see the sharpest spike in real rates as inflation falls from recent high levels, but they should fall again in 2021. In Korea and Singapore, real rates are set to fall, and to turn negative by 2021.

While interest rates have been falling in both developed and emerging APAC markets, interest rates are significantly higher in emerging markets. For example, the effective short-term rate in India as of Q2 2020 is about 5.5%, and even with CPI inflation of 3.9% the real short-term interest rate stands at 1.6% - a level which looks set to rise over the next few quarters. Likewise, in Indonesia, the effective short-term interest rate is currently about 4.8%, and the real short-term interest rate is 2.2%, with little scope to fall.

A key issue for emerging markets is that considerations of currency stability limit scope for further rate cuts. For instance, the Indonesian rupiah weakened over February and March against the US dollar (which usually strengthens in times of crisis), although it has firmed since then. If the Bank of Indonesia cuts interest rates again, it risks renewed rupiah depreciation.

Developed property markets therefore look safer than emerging markets in the present environment. In developed markets, very low interest rates:

- push up bond prices, and therefore reduce bond yields
- reduce the risk-free rate used in the capital asset pricing model (CAPM) of equity values
- moderate upward pressure on the capitalisation rates used in commercial property

Figure 3: Real interest rates (2019 – 2023): major APAC developed markets plus China

Source: Oxford Economics as of 14 May 2020
Since the GFC, developed economies around the world have kept interest rates low to stimulate dull growth. As also noted, since the advent of the COVID-19 recession, central banks in APAC and other regions have cut interest rates further from already very low levels.

It is an old rule of professional investment that, if interest rates fall, bond prices rise and bond yields decline. Globally, the decade of low rates has stimulated an unprecedented bull market in government bonds. Upward pressure on bond prices has persisted over most 2020, since investors traditionally buy government bonds for security of income if they expect recession – and the COVID-19 pandemic has prompted the steepest recession since the 1930s. The corporate bond market has fared less well, due to concern about the impact of recession on companies’ cash flows.

A bizarre outcome of the bull market in government bonds has been the accumulation of bonds with negative yields to maturity – i.e. securities which guarantee a nominal loss for investors. The global pile of negative-yielding government and corporate debt stood at USD13.0 trillion as of end-January 2020¹. This total may well have increased since that time.

In APAC, the Japanese ten-year government bond yield has hovered at around zero for three years. As of 12 June, ten-year yields in other big Asian markets range between 0.42% for Taiwan and 2.78% for China, but are nevertheless low by historic standards. A series of rate cuts by the Reserve Bank of Australia has pushed the ten-year bond yield in that market to 0.89%, versus 2.40% three years ago.

> In the US, after a series of rate cuts by the Federal Reserve, as of 12 June the 30-year and 10-year government bond yields stand at 1.41% and 0.68% respectively. While the ten-year yield has risen significantly from this year’s low point of 0.32% as hopes of economic recovery have gradually increased, on a long-run view it is still not far from the lowest level for over a century.

> Globally, the most extreme case of negative yield is Switzerland, where the ten-year government bond yields at −0.47%, followed by Germany on −0.43% (as of 12 June). The UK broke new ground on 20 May by issuing three-year bonds with a negative yield for the first time (−0.003%).

Very low or negative bond yields now commonplace

LOW YIELDS ON BONDS AND EQUITIES INCREASE RELATIVE ATTRACTION OF REAL ESTATE

¹ Source: Financial Times, “Negative-yielding debt sends investors scurrying into gold” (30 January 2020).

Figure 4: Ten-year government bond yields in Asia and US (%)

Sources: S&P Global Market Intelligence, other, as of 9 June 2020
Dividend yields in equity markets under threat

The long global bull market in bonds had helped fuel a global bull market in equities. However, this bull market in equities was heavily dominated by the US and was unevenly spread across other markets. Moreover, equity markets have reacted differently to the COVID-19 crisis: the US market initially fell sharply but has since largely recovered, whereas other markets remain well below their peaks.

> At the present level of 3,002 (11 June), the US S&P 500 equity index has risen 4.4x since its low point during the GFC. After rallying 34% since late March, the index is now about 11% below its all-time high. The yield on the S&P 500 index stands at about 1.9%, but we suspect that this figure is not sustainable given the damage that the COVID-19 recession is widely expected to inflict on US corporate profits and hence dividend income. We assess the outlook for corporate dividend payments further in Part Two of this report.

> Returns on Asian stock markets have been less impressive than in the US, with Chinese markets showing particular volatility. As of early June, dividend yields for major Asian equity markets range from about 2.0% for India through 2.5% for Japan to a more generous 4.9% for Singapore. Again, however, these yields look questionable because corporate profit forecasts have been lowered sharply during the current recession.

Figure 5: Dividend yield of major Asian stock markets plus US (%)

Note. In this chart, we show the FTSE Hong Kong index, whereas on page 3 above we cite the dividend yield for the Hang Seng Index.

Sources: S&P Global Market Intelligence, other, as of 1 June 2020
REAL ESTATE OFFERS MORE APPEALING YIELDS

Compared to low or negative yields on government bonds and the possibility of falling dividend yields for equity markets, the yields offered by real estate assets in APAC markets look attractive. For example:

- As shown in Figure 6 overleaf, yields in the office sector in developed APAC markets range between 2.8% for prime grade Hong Kong offices at the low end and 5.8% for Auckland at the high end¹. Yields on Grade A office assets in emerging markets are higher, ranging up to about 9.0% for Indian cities (and even higher in markets like Vietnam and the Philippines). While it may be true that rental income for office assets is under threat, the pressure is generally less than that on corporate profits in equity markets. We discuss this point further in Part Two of this report.

- In the office sector, in developed APAC markets, the yield spread over ten-year government bonds varies between about 1.7pp for Beijing at the low end and 5.0pp for Auckland at the high end, followed by Sydney and Melbourne on 3.7-3.8pp and Tokyo on 3.5pp. Again, please see Figure 6.

- As shown in Figure 7, logistics assets in China offer yields ranging from 5.2% to 5.9%, implying a spread of 2.4pp to 3.1pp over ten-year government bonds. The highest yields are in South China and then East China, while the highest rent growth is in North China (4.6% on average over five years).

- Also attractive are logistics assets in Singapore (yield 6.0% and spread over bonds 5.1pp, though income growth is low) and logistics/industrial assets in Melbourne and Auckland (yield 5.5-5.6%, spread over bonds 4.6-4.8pp). Seoul is another market where logistics yields exceed 5.0%, while for Sydney and greater Tokyo they lie between 4.0% and 5.0%. Medium-term rent growth prospects for the sector remain solid in most of these markets.

- Yields on retail assets in China and Singapore lie in a range of about 4.2%-6.5%. Retail yields are lower in Tokyo and Hong Kong SAR, in a range of 2.7%-4.5%. However, in the case of retail property there is a greater question over prospects for medium-term rental growth than for office and logistics assets, and in our view even than for hotels.

Please see the forthcoming Part Two of this report for further information on rent growth prospects and our recommended property asset classes.

¹ For Asia, we define property yields as “effective rents” (i.e. headline rents less incentives such as rent-free months) divided by capital values. For Australia, we cite “market/reversionary yield”, defined as assessed net market income divided by the sum of the sale price or the adopted value plus any capital adjustments to the core value such as letting up allowances, capital expenditure and present value of reversions.
FIG. 6: APAC OFFICE MARKETS - YIELDS, YIELD SPREADS, RENT GROWTH

- **Precious/Grade A office yield (%)**
- **Yield spread over 10-year bonds (percentage points)**
- **Annual average rental growth rate (% 2019-2024)**

Sources: S&P Global Intelligence, Financial Times, Colliers International, other
FIG. 7: APAC LOGISTICS/INDUSTRIAL MARKETS: YIELDS, YIELD SPREADS, RENT GROWTH

Note. The yield for South China is an average for Shenzhen and Guangzhou. Sources: S&P Global Intelligence, Financial Times, Colliers International, other.
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