COVID-19: IMPACT ON APAC REAL ESTATE CAPITAL MARKETS

Time to Look Beyond the Downturn

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March 2020

Summary & Recommendations

COVID-19 will cut 2020 growth across Asia, but less so Australia. Asian retail has been hard hit. If the outbreak peaks in H1, with a rebound in H2, investors can pick up assets at good prices now.

> In **China**, we highlight logistics (where activity is moving to Tier 2 cities) and data centres for which demand is surging.

> In **Hong Kong SAR**[1], office and hotel assets offer strong rebound opportunities.

> In **Singapore**, we recommend office and hotel assets for mid to long-term growth.

> In **Japan**, Tokyo offices offer good value and quality logistics assets are attractive. Regional hotels face oversupply.

> **Australia** has the lowest impact from COVID-19. Income growth helps drive capital growth for office and industrial property.

China

Logistics, e-commerce | Data centres

COVID-19 and the huge work-from-home experiment will drive demand for logistics assets and data centres.

Hong Kong

Office | Hotels

Targets for a rebound include strata-titled office space, en-bloc offices in fringe areas, and hotels.

Singapore

Office | Hotels

The impact of COVID-19 is relatively modest. Office and hotel assets are attractive on long-term growth.

Japan

Office | Logistics

Tokyo offices are good value, while limited stock of high-quality logistics assets should underpin rents.

Australia

Firm income growth is helping drive capital growth in office and industrial property. We highlight investment opportunities in biomedical precincts in Australia, especially Melbourne.

Office | Industrial/ Logistics

The outbreak of COVID-19 will sharply lower 2020 GDP growth in China and Hong Kong SAR, and adversely affect the rest of Asia, but less so Australia. The Asian retail sector has been notably hard hit. We assume the outbreak peaks in H1, though the spread of the virus beyond Asia raises the possibility of longer-term disruption. Investment property sales may weaken across Asia in H1, although a recent big investment in Shanghai shows some key real estate players are already looking beyond the likely downturn.

If the outbreak peaks in H1, we foresee a rapid recovery in sentiment in H2, offering the chance to buy assets now. In China, we highlight logistics warehouses, since COVID-19 is further boosting online shopping and thus demand for logistics space, as well as data centres. In Hong Kong, assets to target include en-bloc offices in fringe areas and hotels, whose prices have fallen about 30% from their peak. Industrial assets for conversion remain stable.

Singapore and Japan are slightly less affected by COVID-19. In Singapore, property owners should recycle capital into office and hotel assets for mid to long-term growth. In Japan, Tokyo offices still offer good value with Asia's widest spread over bonds, while low stock of modern logistics warehouses should outweigh high near-term supply, ensuring firm rents. Conversely, COVID-19 compounds the problem of oversupply of smaller, regional hotels.

In Australia, the large regional investment market least affected by COVID-19, income growth is still contributing to capital growth in office and industrial property, and the overall market presents an increasingly rare medium-term income growth opportunity. Australia, above all Melbourne, is a global centre of biomedical research, and we advise investors to look for opportunities in biomedical precincts.

[1] Special Administrative Region [of the People's Republic of China]

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SUMMARY OF MARKET IMPACTS AND RECOMMENDATIONS

China

Impact of COVID-19 so far on investment market

- > Chinese growth has been hit hard, but a sharp rebound in H2 2020 is possible.
- > Adoption of online shopping by senior citizens is further driving growth in logistics. The national work-from-home experiment has boosted already surging demand for data centres.
- > COVID-19 may delay a recovery in office absorption. Business parks tend to house less affected tenant sectors and should be more resilient.

Investment implications looking forward

- > Long-term investors have a chance to hunt for bargains now.
- > E-commerce players and end-users are expanding in new logistics markets in Tier 2 cities; investors and developers need to follow.
- > Much investment is targeting data centres despite high barriers to entry, but investors require adequate expertise.
- > Lower prices for hotel assets may create opportunities for conversion.

Preferred asset classes

- Logistics, e-commerce
- Data centres

Hong Kong

Impact of COVID-19 so far on investment market

- > After a weak 2019 due to social unrest, the hospitality and retail sectors have been further impacted by COVID-19.
- > For hotels, we think this pressure is fully reflected in a 30% drop in prices.
- > The office sector will probably see further pressure on leasing demand in H1.
- > The industrial property sector is stable and has been little affected so far.

Investment implications looking forward

- > Weak investment sales over H1 2020, but with a rapid recovery in sentiment possible from Q2.
- > Look for prime properties in the CBD, as more will be available for sale. Price corrections are likely for retail and hotel assets.
- > Office targets: strata-titled office space and en-bloc offices in fringe areas, e.g. Kowloon East.

Preferred asset classes

- Office
- Hotels (for rebound)
- Industrial (stable, for conversion)

Singapore

Impact of COVID-19 so far on investment market

- > Singapore's strong policy response to COVID-19 has instilled confidence in travellers and investors alike, reinforcing its safe haven status.
- > The previous 29% increase in investment sales over 2003 despite SARS in H1 illustrates the rebound potential from COVID-19 in H2 2020.
- > There will be real estate opportunities as businesses affected by COVID-19 will have to reassess their options.

Investment implications looking forward

- > Hotels, prime CBD offices and city fringe business space offer long-term growth.
- > Strata-titled office, industrial and retail assets may offer discounted purchase opportunities.
- > Singapore will continue to attract talent and occupiers given its safe environment and appeal to both employers and staff.

Preferred asset classes

- Office
- Hotels

Japan

Impact of COVID-19 so far on investment market

- > With bond yields likely to stay close to zero or negative, yield spreads over bonds for Japanese property assets should remain the widest in Asia.
- > Decisions may be delayed due to lower risk appetite, leading to a temporary fall in new investment.
- > Severe price drops are likely to be limited to hotels. Tourist consumption has risen 4.2x over seven years, but supply of hotels has risen 5.9x. High supply has softened the impact of firm demand in popular inbound destinations.

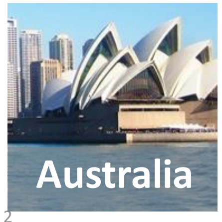
Investment implications looking forward

- > Targets: Grade A offices in Tokyo, which yield about 3.4%.
- > Large rent gaps between offices of different grades within central Tokyo give opportunities to generate profit from better building management.
- > Modern warehouses represent only 5% of logistics stock in greater Tokyo, necessitating major upgrading. Overall logistics rents should stay firm despite high near-term supply.

Preferred asset classes

- Office
- Logistics

Australia



Impact of COVID-19 so far on investment market

- > One or two rate cuts are now more likely due to COVID-19's impact on GDP. This will lower the risk-free rate, making Australian property more attractive.
- > Income growth is still contributing to overall capital growth in some asset classes, particularly office and industrial.
- > So far in 2020, investment volumes are down about one-third from 2019 levels.

Investment implications looking forward

- > Australia presents an increasingly rare income growth opportunity.
- > Biomedical precincts will be a focus of investors, notably from Asia. Australia – above all Melbourne – is a global centre for biomedical research.
- > Industrial landlords should target tenants little impacted by COVID-19, e.g. 3PLs and pharmaceuticals groups.

Preferred asset classes

- Bio-medical precincts

OUTLOOK BY MARKET

China

Focus on logistics and data centres

2020 growth: 4.8%

Oxford Economics has cut its estimate of real GDP growth in 2020 from 6.0% in January to 4.8%, due mainly to the hit to economic activity from COVID-19[1]. H1 2020 is likely to see strain on both the manufacturing and service sectors. However, Colliers assumes that COVID-19 peaks in H1. The experience of SARS in 2003 suggests that economic activity in China may rebound rapidly from H2.

Official response: monetary and fiscal easing

Nominal interest rates have been broadly stable, with expectations of lower inflation explaining the increase in real (i.e. inflation-adjusted) interest rates over 2020–2021 currently predicted by Oxford Economics. However, the People's Bank of China has now eased short-term rates and injected RMB1.7 trillion (USD244 billion) into the money markets. The authorities have launched further monetary and fiscal support measures including tax concession. These easing measures should support confidence among property investors and developers.

Offices: business park most resilient

COVID-19 may delay a recovery in office net absorption after a generally weak 2019. It may also compound existing concern about high supply in Tier 1 Chinese cities. In the near term, business parks look resilient. Business parks tend to accommodate occupier groups which are little affected by COVID-19, or may even be achieving sales growth, such as healthcare, pharmaceuticals, online shopping, online education and online gaming.

Investment outlook for office market

In the Tier 1 Chinese cities, office rents are currently flat or falling. However, these cities have a strong growth outlook and remain popular occupier locations. Based on Colliers' forecasts, in the near term Guangzhou faces lower new supply and less upward pressure on vacancy than other Tier I cities. Opportunities for en-bloc investment here are concentrated in new areas such as Intelligence Business District in Tianhe, Pazhou and Sincere City. On a two to five year view, recovering occupier demand should drive a recovery in rental growth in Shanghai, Beijing and Shenzhen.

Implications of China's enforced work-from-home experiment in Q1 2020

- Senior citizens, who were out of reach for e-commerce, are adopting online shopping since they cannot go out. Further, pent-up demand points to a recovery in retail and e-commerce activity in H2. This bodes well for further growth in the logistics sector.
- The national telecommuting experiment should drive further growth in data usage (already surging due to the spread of cloud computing and 5G mobile), and thus boost demand for data centres.

Looking beyond the downturn

Hongkong Land announced a USD4.4 billion investment in Shanghai on 20 February 2020[2], in the midst of the downturn caused by COVID-19. The site in the Xuhui West Bund district will be used for mixed-use development with estimated gross floor area of 1.09 million square metres (11.7 million square feet), and is due for completion in 2027. This is a major vote of confidence in Shanghai, and shows the potential for a recovery in investment levels from H2.

Impact of COVID-19 so far for investment

- Chinese economic growth will slow materially in 2020, but with the pressure concentrated in H1. There may be a steep rebound in H2.
- COVD-19 should drive further growth in the logistics sector and in demand for data centres.
- Business parks ought to show resilient demand for office space, since they tend to accommodate tenant sectors less affected by COVID-19.

Investment implications looking forward

- Cash-strapped asset owners may be more flexible on price expectations.
- Long-term investors have a chance to hunt for bargains now.
- Firm logistics growth should continue, but e-commerce players and end-users are expanding in new markets in Tier 2 cities; investors and developers need to follow.
- Much investment is targeting data centres despite high barriers to entry, but investors need adequate expertise.
- Declines in the prices of hotel assets may create opportunities for conversion to offices, or rental/serviced apartments.

Preferred asset classes

- Logistics, e-commerce
- Data centres

[1] See "China: Very weak data points towards sub-5% growth in 2020" (Oxford Economics, 2 March 2020).

Hard hit, but downturn gives chance to buy

2020 growth −2.8%, but sentiment has not collapsed

Oxford Economics has cut its forecast for 2020 real GDP growth from −1.4% to −2.8%. After −1.2% in 2019, this implies two years of recession. Since COVID-19 hit Hong Kong in early 2020, the stock market has fallen 8% from a high on 17 January, indicating a decline but not a collapse in market sentiment.

Market impact of COVID-19

So far, COVID-19 has hit the retail and hospitality sectors hardest (see discussion at right). COVID-19 may further depress leasing demand and office rents in H1, but we expect a rebound in H2. We reaffirm our forecast that average Hong Kong and Central rents will fall by 8% and 13% respectively over 2020 as a whole.

Interest rates still ultra-low

Hong Kong has had negative real interest rates ever since the Global Financial Crisis of 2008-09. With Hong Kong interest rates effectively tied to US rates by the territory's currency peg, this situation is unlikely to change any time soon. Negative real rates should support investment demand.

Investment: time to treasure hunt

Investors should sell long-held assets to secure capital gains. Office prices ought to rally once demand returns. Investors should look at hotels, whose prices are down sharply.

The outbreak of COVID-19 compounds Hong Kong SAR's[1] recent problems, i.e. large protests, the lagging effects of the US-China trade war, and long-term pressures on the finance sector. Assuming that COVID-19 peaks within H1 2020, we expect:

- Travel and tourism, which makes up 18% of GDP[2] in Hong Kong, to weaken again in 2020, further reducing hotel occupancy. In some cases occupancy rates have fallen to 10-20% or even lower[1].
- Further pressure on luxury retail sales, and lower demand for luxury retail space.

Impact of COVID-19 so far for investment

- After a weak 2019 due to social unrest, the hospitality and retail sectors have been further impacted by COVID-19. For hotels, we think this pressure is fully reflected in a drop in prices of about 30% from their peak.
- The office sector will probably see further pressure on leasing demand in H1.
- The industrial property sector has been little affected, and industrial assets for conversion are stable and safe.

Investment implications looking forward

- Weak investment sales over H1, but with a recovery in sentiment from Q2.
- Buyers may find more prime assets around the CBD. Greater price corrections are likely for retail and hotel assets.
- Office targets: strata-titled space and en-bloc assets in fringe areas, e.g. Kowloon East.

Preferred asset classes

- Office
- Hotels (for rebound)
- Industrial (stable)

Impact less severe than HK, again a chance to invest

2020 growth: 1.0%

Oxford Economics has cut its estimate of 2020 real GDP growth from 1.4% to 1.0%. The STI stock index fell 7.5% over 22 January-28 February, signalling weaker sentiment.

Safe haven status despite near-term impact on hotels and retail

Singapore is a regional wealth hub and safe haven which will increasingly attract more capital in the long run especially in light of how it has handled COVID-19. In the near term, hotels have been affected as visitor arrivals fall and events are cancelled. Retail sales, notably in F&B and tourist spots, are down 30-80%[2]. If COVID-19 is contained in H1, most sectors should recover by end-2020.

Strong policy response

The 18 February budget included a SGD4.0 (USD2.9) billion Stabilization and Support Package to help enterprises and workers through this crisis. Hotels will get a 30% property tax rebate; retail properties will get a 15% property tax rebate. Further off-budget measures may be adopted.

Besides, further monetary easing from the central bank is likely when it meets in April. Real interest rates are falling towards zero, and these loose monetary conditions should persist.

Investment: hunt for opportunities

Investors should focus on long-term demand drivers. Hotels, prime CBD offices and city fringe business space offer long-term growth.

Singapore is an open economy driven by international trade flows and hence vulnerable to slowdown in China as well as the domestic market. Since China accounts for a far larger proportion of the global economy than in 2003, the impact of COVID-19 on Singapore is likely to be more severe than was the case with SARS in 2003. Nevertheless, we expect Singapore to be less affected than Hong Kong or mainland Chinese cities.

[1] See SCMP article at https://www.scmp.com/business/article/3052937/hong-kong-hoteliers-say-markets-disaster-90-cent-rooms-stay-vacant-amid. [2] Source: CNA 24 February 2020.

Impact of COVID-19 so far for investment

- Singapore's strong policy response to COVID-19 has instilled confidence in travellers and investors alike, reinforcing its safe haven status.
- According to RCA, real estate investment sales in Singapore fell 63% QOQ and 5% QOQ in Q1 and Q2 2003 respectively as SARS hit confidence. However, after a strong rebound in H2 2003, total investment for the year reached SGD3.2 billion (up 29%).
- These figures highlight the sharp potential rebound in H2 2020 from COVID-19. We keep our forecast for 2020 investment sales to be up 6% to SGD31.3 billion.

Implications looking forward

- Hotels, prime CBD offices, city fringe business space offer long-term growth.
- Strata-titled office, industrial and retail assets may offer distressed purchase opportunities.
- Singapore will continue to attract talent and occupiers given its safe environment and appeal to both employers and staff.

Preferred asset classes

Office

Hotels

Japan

Limited impact due to fixed rent structure and ample liquidity support

2020 growth: close to zero

COVID-19 compounds other pressures on the Japanese economy: weak domestic demand due to the consumption tax hike and dull wages, and slowing trade. Oxford Economics forecasts real GDP growth of 0.3% in 2020, but this estimate looks vulnerable to downgrade.

Monetary conditions loose

Japan has limited fiscal flexibility, but minimal funding concerns. The latest budget measures are largely limited to temporary funding support for SMEs. Loose monetary conditions persist, with heavily negative real short-term interest rates and slightly negative ten-year bond yields.

Focus on Tier 2 hotels

COVID-19 has exacerbated concern over hotel supply in popular tourist destinations. High supply prior to the Tokyo Olympics, equaling 30% and 65% of stock in Osaka and Kyoto, was a worry even before COVID-19. We see oversupply risk as limited to smaller regional hotels, given their high reliance on total tourist consumption (29% versus 20% for all hotels).

Investment drivers positive

Long-run demand drivers remain intact for real estate investment, notably office and logistics. Since yields in other asset classes are also falling, weight of liquidity matters more than a pause in risk-taking; total deals are dropping, but this has been offset by larger en-bloc deals by global investors over the past several quarters.

Japan has a large domestic market base that has been less dependent on trade flows. However, rising inbound tourists, earning an annual net trade surplus of JPY4.5 trillion (USD41 billion), have an indirect impact through the China slowdown. Since Greater China and South Korea made up 56% and 9% of 2019 inbound tourists, COVID-19 should have a noticeable impact on popular tourist destinations like Osaka and Kyoto.

Fading domestic demand poses more urgent concerns over risk appetite. Although most landlords are likely to be protected under Japan's fixed rent structure, some tenants could suffer in the absence of government rebate measures, given that monthly headline retail sales in certain tourist destinations are down over 60% in the wake of COVID-19.

Impact of COVID-19 so far for investment

- With bond yields likely to stay close to zero or negative, yield spreads over bonds for Japanese property assets should remain the widest in Asia.
- Investment decisions may be delayed due to lower risk appetite, leading to a temporary fall in new investment for the duration of the virus outbreak.
- Severe price declines are likely to be limited to hospitality assets. Tourist consumption has risen 4.2x to JPY 4.5 trillion over seven years, but supply of hotels nationally has risen 5.9x to 304,000 sq. metres. High supply has softened the impact of firm demand in popular inbound destinations.

Investment implications looking forward

- We still favour Grade A offices in Tokyo. These yield about 3.4% and so give a spread of 3.4pp over zero-yielding bonds.
- Large rent gaps between offices of different grades within central Tokyo give opportunities to generate profit from better building management.
- Modern warehouses represent only 5% of logistics stock in greater Tokyo, necessitating major upgrading. Overall logistics rents should stay firm despite high near-term supply.

Preferred asset classes

Office

Logistics

Attractive for medium-term income growth; target biomedical precincts

Investment volumes are down by about one-third from 2019 levels

Income growth is still contributing to overall capital growth in some asset classes, particularly office and industrial

Biomedical precincts will be a focus of investors, particularly from Asia

Impact of COVID-19 so far for investment

Overall market

- One or rate cuts now look even more likely due to impact of coronavirus on Q1 2020 GDP. This will in turn lower the risk-free rate, making Australian property even more attractive.
- Rental growth outlook has yet to be impacted – income growth is still contributing to overall capital growth in some asset classes, particularly office and industrial. This in turn has increased the relative attractiveness of Australian property assets.
- The latest increase in coronavirus cases has led to further "safe haven" investment flows into gold and government bonds.
- So far in 2020, investment volumes are down by about one-third from 2019 levels. There is some evidence of weaker interest from cross-border investors, particularly from China and Hong Kong. In 2020 to date, foreign capital has made up 33% of all investment into Australian commercial real estate, down from 41% in 2019. However, depreciation of the Australian dollar could present a buying opportunity for overseas buyers.

Industrial property

- Industrial occupiers may delay expansion or relocation decisions in the short term as they adopt a "wait and see" approach and instead focus on any potential impacts of the virus to their business.
- Like retail tenants, businesses relying on goods and materials from China will experience supply chain disruptions in the short term as factories undergo a mandatory shutdown period. Sourcing materials from elsewhere will have a knock-on effect to development costs and schedules.

Investment implications looking forward

Overall market

- Investors should look to Australia as an increasingly rare income growth opportunity in the short to medium term
- Biomedical precincts will be a focus of investors, particularly from Asia. Australia – above all Melbourne – is one of the world's global centres for biomedical research. Look for investment opportunities in these precincts.

Industrial property market

Colliers believes that industrial landlords should:

- Target occupiers who are unimpacted or who will benefit from COVID-19 such as 3PLs and pharmaceutical occupiers.
- Proactively contact clients who may be impacted and listen to their needs.
- With development times likely to be impacted by material shortages, engage with affected occupiers regarding short-term leases on vacant space.

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Date of publication
3 March 2020

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