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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

PRICING IN A TRADE WAR

PERE's Asia roundtable is underwriting East-West macro issues

Bracing for the next shock

In a late-cycle environment with growing uncertainty surrounding macro events like the US-China trade war, real estate managers are thinking about how to make their strategies resilient ahead of a potential downturn. By Arshiya Khullar

For several months now, China and the US have been clashing over trade, with both countries imposing sweeping tariffs on one another's goods. At press time, Bloomberg reported the US government's plans of introducing additional tariffs by this month – on top of the $250 billion already reportedly imposed – if a planned meeting between presidents Xi Jinping and Donald Trump does not yield results.

With the trade war threatening to be one of the biggest geopolitical frictions of 2018, it has fueled private real estate market uncertainty. For the six participants at *PERE*'s annual Asia roundtable – executives working for some of the region's most prominent real estate investment managers – further escalation in these tensions is a major point of concern.

Jason Lee, chief investment officer for Asia-Pacific at the Boston-headquartered investment manager AEW Asia, says cap-rate compression is now a global phenomenon, and Asia has the advantage of having a growth story. However, the "elephant in the room," in his view, is where the trade war is heading. "I don't think anyone knows the answer yet."

"What is value-add is now core and core has become super-core"
Rohan Sikri

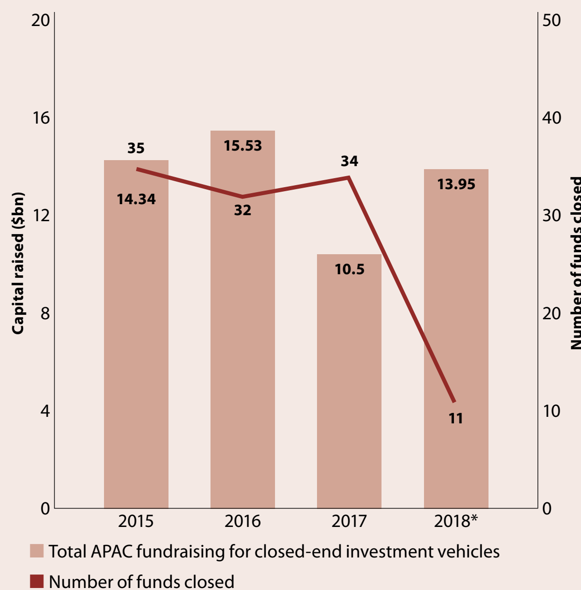
"In the past 12 months, there has been a shift in risk appetite and overall sentiment," agrees Claire Tang, head of acquisitions in China for Chicago-based investment firm LaSalle Investment Management. "Investors are now more focused on macro risks, including rising interest rates and trade wars, rather than property fundamentals."

Alongside these macro concerns are the challenges of investing in a late-cycle environment, which is a global phenomenon. This is prompting managers to deliberate on how to position their strategies to achieve the best outcome in these uncertain times.

From left: Rohan Sikri, Claire Tang, Louise Kavanagh, Jason Lee, Bernhard Karas, Richard van den Berg

More from less

More capital has been raised for APAC closed-end real estate funds in the first three quarters of 2018 than the whole of 2017, even if the number to close has dramatically decreased



** as of Q3, 2018*

Source: PERE

"As long as there is no material effect on the occupier market here in the region, we feel that the trade war risk is adequately priced," says Bernhard Karas, Investment Specialist – Real Estate, Asia-Pacific at DWS (formerly Deutsche Asset Management). "Pricing will have to be reset only if there is a spill-over in the occupier market. Our view is that it will impact US real estate as much as real estate here in the region."

Others, like Richard van den Berg, fund manager and non-executive director at the London-based real estate investment manager M&G Real Estate, believe the trade war impact might not be as severe as anticipated – and there could even be some upside.

"The first signs of the trade war have resulted in China and Japan getting closer to each other and China even more actively reaching out to other countries through the Belt and Road initiative," he says. "Potentially, part of the effects of the trade war with the US could be compensated by increased trade between China and other countries in the region."

Following the money

The good news is there is abundant liquidity. According to *PERE* data, around $13.96 billion has been raised for Asia-Pacific-focused closed-end real estate investment vehicles as of the third quarter of 2018. With one quarter remaining, the fundraising total has already surpassed the $10.5 billion raised in the whole of 2017.

Both AEW Asia and LaSalle Investment Management, for instance, have raised bigger-sized vehicles this year. AEW raised $1.12 billion for AEW Value Investors Asia III in June, significantly more than the $640 million raised for the predecessor in 2016. Meanwhile, the $1.15 billion LaSalle Asia Opportunity Fund (LAOF) V, which closed in April, is over double the size of the $485 million LAOF IV.

But is much of this capital going toward higher risk strategies? According to *PERE*'s *2018 APAC Fund Manager Guide*, 68 percent of the total capital raised in the first half of 2018 was for opportunistic investments.

Louise Kavanagh is managing director at TH Real Estate, an affiliate of Nuveen, investment manager of the New York-based Teachers Insurance and Annuity Association (TIAA). Her firm is currently in the market with its debut open-ended core vehicle in Asia-Pacific, and announced in November having raised $230 million so far, with an overall target of $2 billion after the first five years.

Kavanagh says her recent conversations with a number of US investors have delivered a resounding message – one that

Bernhard Karas

Investment specialist – Real Estate, Asia-Pacific, DWS

Karas joined DWS as a real estate investment specialist in 2014, after working as a director in the capital markets group at Cushman & Wakefield. He has over 17 years of experience of working with global institutional investors on unlisted real estate investment strategies.

Claire Tang

Head of acquisitions – China, LaSalle Investment Management

Tang is based in Shanghai and has been working with LaSalle Investment Management since 2007. With over 10 years of experience in real estate and investment management, specializing in the Greater China region, Tang has also previously worked with Jones Lang LaSalle and GE Asset Management.

Louise Kavanagh

Managing director, TH Real Estate

Kavanagh joined TH Real Estate as managing director for funds management in late 2017. She was previously the fund manager for Invesco Real Estate's open-ended core/core-plus vehicle in the region. With more than 17 years of experience in the real estate and funds management industry, she has also served as a director at RREEF Real Estate Asia-Pacific.

Less correlated: Asian markets are less correlated than those in the West

differs from the last few years. "[Investors are] focusing on core investments in the US because of the perceived near-term growth and recovery. They are saying they now will look at their home market after allocating capital to all open-end core funds in Asia for the past several years," she says. "Potentially, they are looking to distill down the number of managers in Asia and focus on sector or strategy specific managers now."

Kavanagh shares data from the industry body ANREV, which tracked unlisted Asia-Pacific funds from 2010-17. According to the association, the reward-to-risk ratio for core investments is 7.47 percent, while for opportunistic it is 1.61 percent.

"In some ways, core has had a bit of a Goldilocks period. Everything had been just right in Asia to raise funds and deploy capital. Now there is sentiment shift. It's likely the risk-return ratio will also change for core going forward."

Rohan Sikri, senior partner at the emerging markets-focused manager Xander Investment Management, says there is now generally less appreciation of risk across different strategies, whether it is value-add or core, and it is manifesting in different ways.

"The question is how do you underwrite these deals? What is value-add is now core and core has become super-core," he says. "The thresholds keep moving because people have capital to deploy and opportunities for traditional capital allocators are few and far between. We can justify to ourselves

Kavanaugh expects: Asia's risk-return ratios to change for core

by saying everyone's return thresholds have dropped because of global liquidity. But I think that is more of an excuse than justification."

What complicates matters is the blurring lines between the generally accepted definitions of different investment strategies, especially in Asia. There is no ODCI index here, for instance, to explain what managers are really considered opportunistic or core in their strategy. Additionally, most weighted average lease expiry (WALE) periods in Asia are typically three to five years, shorter than other markets.

"If we look at the WALES in the US and Europe, it becomes a lot easier to define assets as core rather than core-plus or value-add. But in Asia, you have to underwrite the leases for a short period of time, and that is where the definition of core could become blurry," explains AEW's Lee.

Furthermore, different managers could have different interpretations of each strategy.

"The definition of value-add and core-plus, and core-plus and core is all very grey. A building that is 40 percent leased and requires $30 million of capital expenditure is considered value-add, and a building that is 90 percent leased, with rents churning in four years, is value-add too," adds Sikri.

Income focus

Irrespective of the label given to an investment, the period of cap-rate compression is generally coming to an end, which is

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> **Louise Kavanagh**

Rohan Sikri

Senior partner
Xander Investment Management

Based in Singapore, Sikri heads the firm's real estate investment management program for Asia. He is also chair of the investment committee for Xander Funds and the credit committee for Xander Finance. From 2005 to 2010, Sikri co-founded and supervised Xander India's investment program and the creation of a $1.4 billion equity investment portfolio.

Jason Lee

Chief investment officer – Asia-Pacific
AEW Asia

Lee is responsible for implementing the firm's investment strategy, including sourcing, structuring and underwriting of new investment opportunities. In his 22 years of real estate investment experience, he has also worked as a director of Merrill Lynch's Asia opportunistic real estate fund and the Global Principal Investments Group.

Richard van den Berg

Fund manager,
M&G Real Estate

Van den Berg is the fund manager of the M&G Asia Property Fund, responsible for investment strategy and oversight of acquisitions, divestments and asset management. He joined M&G Real Estate in August 2017. Van den Berg has been actively involved in Asian real estate management since 1989 with previous roles in Hong Kong at ING Real Estate and CBRE Global Investors, including others.

changing how and where managers choose to deploy capital.

"One of the biggest mistakes you could make in the current cycle as a core investor is to move to Grade B assets or secondary locations, chasing an absolute level of yield," adds Karas. "As a fiduciary manager, discipline and communication on where we are in the cycle with clients is key."

Some markets like Australia have witnessed continued downward pressure on cap rates, falling below historical norms in the East Coast markets, says Kavanagh. She says an A grade premium office asset in Sydney, for instance, would be trading at a 4-4.5 percent cap rate.

"The Federal Reserve has implemented eight interest rate rises since December 2015, and I think the knock-on effect may be more pronounced in some markets where the private debt fundamentals are out of balance, such as Australia," she adds. "The question for all of us is: how do we deliver a durable income for the future? Should we pay to insulate against perceived risks or even unperceived risks such as a black swan event that you cannot control?"

Expectedly, this will change how total returns are generated. "For commercial assets, in the recent past, a large part of total returns has been coming from cap-rate compression. However, in the next five years, it will come from income," says Sikri. "That is where we are focused."

M&G Real Estate operates the biggest open-ended real estate fund in Asia-Pacific, M&G Asia Property Fund, which has assets valued at around $4.7 billion currently. Van den Berg says total returns for core investors over the last five years have generally been above 10 percent annually, of which more than half was related to capital value increases mostly fueled by cap-rate compression. But now the focus is more on ensuring a stable income stream.

"In our fund, around two-thirds of our leases have an average annual escalation of more than 3 percent which, in itself, apart from providing a strong income stream, also results in an equivalent value increase of the assets," he explains. "As such, a robust and diversified portfolio with long-term leases with logged-in annual escalation rates is the best defense against stabilizing cap-rates."

Global investors are aware of the lowering returns, the roundtable concurs. "They are more concerned about changing the risk profile of a core fund to chase historic returns than accepting the changing market conditions," van den Berg notes.

"A positive factor about the Asia-Pacific markets is that they are much less correlated," Karas adds. "It pays to focus on income and diversification and utilize the advantage of less correlated markets in the region, where depending on the cycle, you may still find relative value."

And it is not just core managers that are thinking about driving returns through income growth. "It is always important to have an income component in the value-add strategy. It gives a little bit more flexibility to achieve that increased [net operating income] during the holding period. Especially in a cycle like this, you want to have the opportunity to improve income," says AEW's Lee. "One should have a lower risk profile on the rent reversion and have a shorter WALE, [rather] than spend a lot more capex and have more execution risk, for instance."

Finding opportunities in uncertainty

In a discussion involving core, opportunistic and value-add managers, comparisons between different strategies is inevitable. For the core managers in the room, the general view is that the timing risk for value-add and opportunistic investments, which have a limited lifespan, has increased at this point in the cycle. To this, LaSalle's Tang says her firm relies

on development margin and hands-on asset management from the investments made from its opportunistic fund to hit returns, rather than cap-rate compression.

Those operating in the higher risk-and-return spectrum also recognize the opportunities that could be potentially created from capital markets volatility. Two of the region's biggest economies, India and China, are ramping up deleveraging efforts to clean up the balance sheets of some of their large debt-laden conglomerates. The latest example in India is the ongoing liquidity crisis at Infrastructure Leasing & Financial Services, one of the biggest infrastructure developers and non-banking financial institutions in India. A government-appointed board is currently weighing possible bailout measures for the firm, which has a reported debt of 910 billion rupees ($12.3 billion; €10.8 billion).

Meanwhile, China's battle against debt deleveraging, coupled with the recent collapse of the shadow banking sector, has had a "rapid and direct impact on real estate liquidity in China," notes Tang. "There has been significant expansion in the bond yields of listed Chinese developers versus a year ago. The availability of credit and debt cost for some of these developers has led to asset buying opportunities for us," she says.

The opportunities extend to Hong Kong, as well. As such, van den Berg says investment opportunities in the city are becoming interesting for the first time in years. "Initially, this may be through structured deals such as structuring a loan versus a bond, or convertible equity or preferred equity into the investment," he adds. "We can be patient because we think the deleveraging process will continue for the foreseeable future and more attractive opportunities will present themselves."

With each investment strategy facing its own challenges at this point in the cycle, it is the investors' appetite for risk and the resilience of the strategy that will ultimately determine the winners and losers in the world's eastern private real estate marketplace. □

Seoul outlier

The Korean capital has seen record transaction volumes this year on the back of strong office market fundamentals

At a time when most gateway markets in Asia-Pacific have reached the near-end of the cap-rate compression cycle, the South Korean capital stands out. As M&G's Richard van den Berg notes, there is still potential for a cap-rate compression in Seoul, particularly the central business district.

"We believe that the market has bottomed out in the CBD and Gangnam and will see a combination of strong rental growth and further capital value increase against Yeouido, which will continue to face headwinds with substantial over-supply," he says. "Interestingly, the correlation between Yeouido and the other two office areas is low."

Seoul has also seen record transaction volumes and some trophy deals. In the second quarter of 2018, total office investment volume was estimated by property services firm Savills to be 3.8 trillion won ($3.3 billion; €2.9 billion), nearly triple the ten-year average for the same period. Several deals of over 200 billion won have concluded off late, Savills noted, but the biggest by far was M&G's $1.05 billion acquisition of Centropolis Towers in partnership with two Korean pension funds in August.

Centropolis: M&G's biggest acquisition in Seoul via its core strategy

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