AEW RESEARCH

AEW Asia Pacific Research Perspective

Q4 2023

AEW

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New Year, Familiar Themes

RATE CUTS EXPECTED, BUT OPINIONS ON SPEED AND MAGNITUDE ARE WIDE

- As growth slows and inflation moves closer to target levels, attention has shifted to the timing and speed of rate cuts.
- At the start of the year, swap markets were pricing in aggressive rate cuts in the U.S. from as early as March 2024. However, this sentiment has diminished due to labor market strength, bumpy disinflation, and the Federal Reserve's rhetoric, all indicating a cautious approach and suggesting that patience will be exercised. For major Asia Pacific markets like South Korea, Singapore and Australia, the easing path is likely to begin within H2 2024.
- China remains a challenge - recent support measures have yet to see uninterrupted improvement. The economy is trapped in a negative feedback loop, where waning confidence hampers the effectiveness of existing policy stimuli.
- Japan, on the other hand, is on the path to interest rate normalization, ending close to a decade of negative interest rates. This will likely undoubtedly impact currency, levered returns, and investment appetite for real estate.

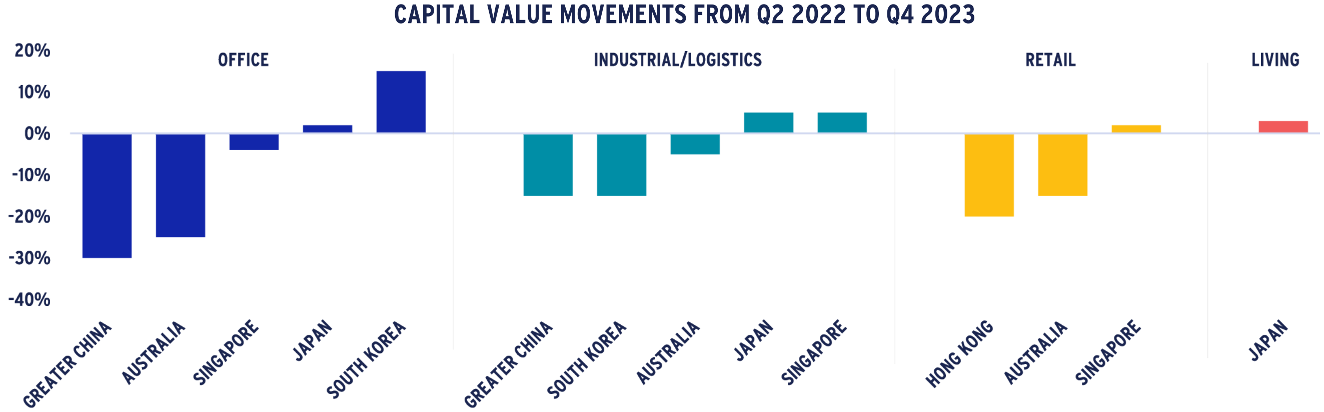
MORE CERTAINTY ON REPRICING, REFINANCING STRESS PRESENTS OPPORTUNITY WHILE DRY POWDER HITS ALL TIME HIGH

- Valuation uncertainty dominated 2023, but clarity is expected in 2024.
- Global investment volumes experienced a more than 50% decline in 2023, but in Asia Pacific alone, the decline was smaller, at just 37% year-on-year. Japan's divergent monetary policy supported activity, with the market accounting for a third of all real estate transactions in 2023. Sectors where the cost of debt was accretive witnessed a healthier purchasing environment, including Singapore industrial and Australian retail, which notably improved in Q4.
- Opportunities for discounted entry will increase as asset owners rebalance portfolios, reallocate capital, and manage refinancing risk. AEW Research estimates a debt funding gap of approximately USD 5.3 billion in 2024, with the most significant refinancing stress evident in Australian and Chinese offices over the next 12 months.
- With increased confidence in values and interest rates, alongside more opportunities for good value emerging, investment activity is poised to improve in 2024. Dry powder for real estate is also at a record high of USD 62 billion, which will exert pressure on deployment. Activity is likely to further intensify in H2 2024, with an anticipated overall 15% year-on-year increase in volumes.

GROWTH MOMENTUM, CYCLICAL OPPORTUNITIES AND VALUE PROPOSITIONS

- Asia Pacific continues to benefit from its early-stage growth position in key sectors such as living (including related alternatives) and new economy sectors like life sciences, cold storage and data centers. Many of these markets are underserved or facing supply constraints, exacerbating rent cycles and increasing income growth potential.
- The hospitality sector experienced a robust year in 2023, buoyed by a recovery in tourism and service consumption. Occupancy rates have improved, and room rates have reached new peaks in key cities of Japan and South Korea. While opportunities still exist to acquire under-rented or under-capitalized properties, the window for further growth in room rates is narrowing.
- Some office markets offer cyclical opportunities, while the retail sector in Australia indicates a favorable value proposition.
- Looking ahead to the next five years, the outlook can be divided into two parts. While the logistics and multifamily sectors present stronger unlevered total returns in the near-term (2024 to 2025) supported by income growth, the office market shows a better outlook from 2026 to 2028 supported by cap rate compression. Keeping mindful of variations in demand-supply cycles across the region, confidence remains that 2024 could offer a favorable vintage for capital deployment.

CAPITAL VALUE MOVEMENTS FROM Q2 2022 TO Q4 2023



Source: AEW Research, as of 29 Jan 2024

Focus on Unique Growth Drivers and Rate Cuts

ASIA PACIFIC ECONOMY REMAINS FRAGILE, BUT UNIQUE GROWTH DRIVERS EXIST

- The global economy avoided recession in 2023, but 2024 appears precarious for certain markets. Currently, the U.S. remains strong, but there are concerns about recession impacting some European economies.
- In Asia Pacific, we believe recession probabilities remain below 40%. Australia faces the greatest risk, with both fiscal and monetary policies weighing on the domestic economy. Meanwhile, South Korea and Singapore lead growth prospects for the next 12 months, driven by a recovery in semiconductor and high-value-added manufacturing exports.
- Japan’s tourism rebound was a strong theme in 2023, but it is anticipated that further growth in this segment will be limited. Leaning into Japan’s structural shift out of a stagnant price growth will be interesting.
- China's economy is facing structural weaknesses, primarily driven by a sluggish housing market and a lack of confidence among domestic consumers and investors. Despite the Chinese government's efforts to stimulate the economy through policy measures in early 2024, there remains skepticism about the effectiveness of these actions.

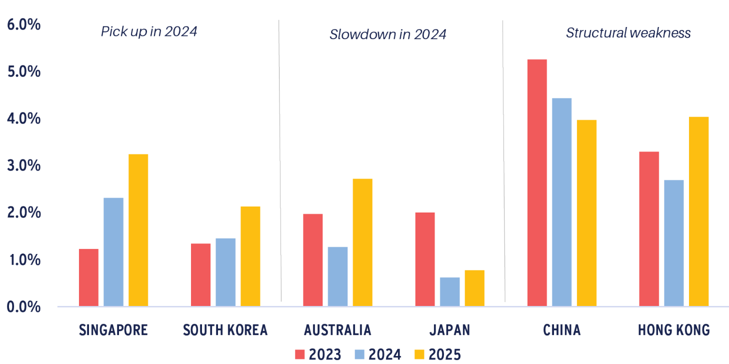
CONSUMPTION SLOWDOWN, TOURISM GROWTH TO MODERATE

- Various economic indicators suggest a moderation in business investment, hiring sentiment, and consumer spending trends.
- While retail sales up to November 2023 exceeded expectations, forward-looking consumption indicators suggest a decrease in spending appetite.
- Similarly, although the tourism recovery may have additional momentum, we are tempering our optimism for the year due to anticipated consumer weakness. Additionally, there is a belief that further growth hinges on the Chinese outbound traveler market, which is unlikely to materialize given the circumstances in their domestic economy.

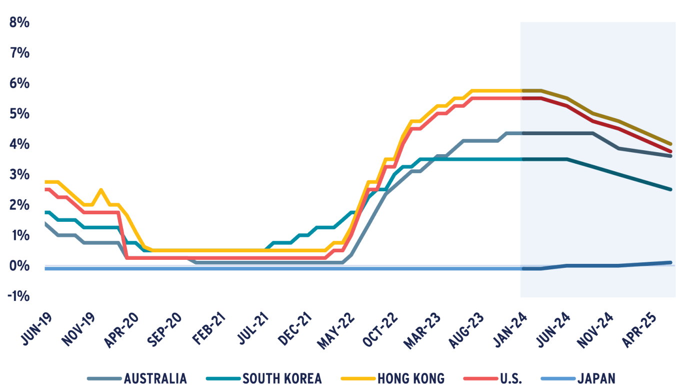
MONETARY POLICY EXPECTATIONS ARE DIVERSE

- Our expectation on timing of rate cuts have shifted; loosening remains likely in Q3 2024 for South Korea, Singapore, while for Australia it might be closer to Q4 as inflation remains stubborn and several fiscal policy changes, alongside expected population growth could challenge the inflation moderation path. Despite expected rate cuts in 2024, these will be limited.
- Meanwhile the BoJ in Japan is expected to move away from negative interest rate policy (as early as March or as late as July 2024) once the outcomes of the Spring wage negotiations are finalized. Floating debt costs (the 3M TIBOR) have been relatively stable to date however the fixed term swap rates (3 and 5 years) have risen by about 10 to 15 bps from their 2023 average levels.
- The PBOC is expected to continue to provide extra liquidity throughout the year, with its first cut of 2024 at 50 bps to the RRR – we expect more to come as the PBOC hinted it has more tools in the pipeline.
- Currency volatility should continue as in H1 2024 as market expectations keep shifting. Beyond this, sustained local currency appreciation against the USD remain high, especially if the Fed stays cuts ahead of Asia Pacific central banks.

ASIA PACIFIC GDP GROWTH 2023 TO 2025



MONETARY POLICY MOVEMENT EXPECTATIONS AS OF JAN 2024



Source: Oxford Economics, Bloomberg & AEW Research, as of end January 2024

Fine-tune Strategies While Market Dynamics in Flux

OFFICE

LEASING CONDITIONS SLOW FURTHER IN Q4 2023, DEMAND DRIVERS REMAIN WEAK IN 2024

Leasing activity typically declines during the final months of the calendar year, so the slowdown observed in Q4 2023 was not particularly surprising. However, it is worth noting that this slowdown was pronounced in Australia's primary capital cities and China. In both regions, the large vacancy overhang and continued supply will further contribute to the declining rental trend throughout 2024. Across the markets we monitor, small tenant demand remains a key leasing driver (units under 1,000 sqft), with these occupiers showing a preference for fitted out suites. While certain markets like Brisbane, Perth, and Seoul have experienced robust demand growth in previous years, we remain cautious of a sustained elevated leasing trend as economic drivers weaken. In Tokyo, recent months have witnessed an increase in demand for Grade A space, alongside several new completions.

OFFICE REPRICING LIKELY TO TAKE SHAPE IN 2024

The global office sector is grappling with significant concerns regarding repricing. Specifically in the Asia Pacific region, there is an estimated debt funding gap (in the office sector) of around $2.4 billion expected over the next 12 months. As investors worldwide shift away from this asset class, opportunities may emerge as investors rebalance their portfolios. It is anticipated that properties in Sydney could see repricing by as much as 20 to 30%, while Melbourne may experience even more pronounced declines due to the introduction of the new absentee land surcharge. This surcharge effectively doubles the tax rate for foreign investors, leading to further erosion of returns and potentially driving up yields even higher.

LOGISTICS

DEMAND READJUSTS LOWER, SOME MARKETS STILL REMAIN LANDLORD FAVORABLE DUE TO SUPPLY DELAYS

The logistics sector, which was previously experiencing strong growth, is now slowing down as occupiers in multiple markets revert to a just-in-time inventory system, reversing the previous just-in-case approach post-COVID lockdowns. While supply chain disruptions remain a concern, their impact on inventory management has lessened compared to 2021-2022. Supply is increasing across various submarkets, but challenges with construction and financing are creating delays. Australia's markets show the most favorable conditions for landlords, with worst-case vacancy expected at only 3.5% by year-end, though affordability concerns arise as rents potentially exceed economic fundamentals. In Greater Seoul, demand for modern facility upgrades is evident but concentrated among a few key players. Meanwhile, Japan sees rising vacancy rates in newly constructed properties, which are slower to lease compared to prior years.

INVESTOR INTEREST STRONG IN MARKETS WITH POSITIVE YIELD SPREADS

Investor interest in the sector remains strong, especially as capital gets redirected away from offices. In Singapore and Japan, investor activity is up, showing year-on-year increases of around 40%. These markets benefit from positive yield spreads, and the influx of capital has led to a slight compression in yields. Conversely, in Australia and Greater Seoul, yields have risen by 70 to 150 basis points from their peak levels. This increase in yields occurred as transaction volumes have declined by over 50% compared to the same period last year.

RETAIL

CONSUMER SENTIMENT TURNS CLOUDY, INVESTMENT ACTIVITY MIXED

The outlook for discretionary retail is becoming cloudy as higher interest rates and inflation have impacted consumer spending. Ironically, however, the retail sectors in both Australia and Singapore are experiencing their best performance in years. Major REITs and shopping center landlords in Singapore and Australia are reporting positive leasing spreads and lower vacancy rates. From our perspective, Australia's retail market appears particularly attractive from a valuation standpoint, with yields currently exceeding the cost of debt in many cases. This makes the sector one of the few in the country where debt is accretive.

RESIDENTIAL

STRONG MIGRATION AND IMMIGRATION SUPPORT DEMAND, SUPPLY CHALLENGES BUILD

In Japan, migration patterns have already returned to pre-pandemic levels, supporting multifamily demand in the major cities. Meanwhile, in Australia, extremely strong overseas net migration, low vacancy rates and housing affordability is exacerbating pent-up demand conditions for all kinds of rental housing (BTR, student accommodation, co-living). Both markets are exhibiting strong occupier fundamentals, and the supply shortage today is providing further upside to rental growth story in the near- term.

Office

AUSTRALIA: SECONDARY CITIES LEASE BETTER, OFFICE DEALS IN 2024 WILL CONFIRM PRICING

- In Sydney and Melbourne, consolidation continues to outweigh expansion, and occupied stock has shrunk by around 7% since end 2019 (close to 4 million sq ft).
- Repricing remains a central issue – concluded sales were limited in 2023, but several sales completions are expected in Q1 2024, with declines of up to 35% likely.
- Rising replacement costs are posing challenges to the feasibility of future office projects. Combined with current discounts available, this is creating a case for a countercyclical position, particularly in Sydney's CBD, where a supply shortfall expected over 2025 and 2026 could exert upward pressure on the rental cycle.

SINGAPORE: INVESTMENT ACTIVITY STARTS TO PICK-UP

- Rental weakness played out in 2023; landlords offered lower rents and attractive incentives to maintain occupancy. This decline will continue into H1 2024 as new project completions increases leasing competition.
- During the first ten months of 2023, there were several failed/ stalled enbloc office sales campaigns. However, as the market began to price in rate cuts from Q4 2023, several transactions were announced giving confidence for a more active market in 2024.

HONG KONG: RENT DOWNGRADES, DISTRESSED SALES OR BANK REPOSSESSIONS LIKELY

- Expectations for the next two years have turned more negative with little faith in demand drivers and substantial vacancy overhang. Vacancy rates have surpassed historical peaks (last reached in 1999) and will keep climbing up until 2026, as new take-up lags supply. Rents today are 35% below 2019 levels.
- A growing pool of asset managers are looking to offload their assets, but interest is tepid given weak fundamentals and lost vigor from the mainland. Distressed sales or bank repossession is likely.

CHINA: WEAK LEASING AND INVESTMENT MARKETS

- Leasing demand remains weak and occupier cost consciousness is a prevailing sentiment. Net expansion is uncommon, and in fact, more firms are downsizing at the lease renewal stage today. Landlords of aged buildings are compelled to provide significant rent reductions and incentives as leasing competition increases.
- Many assets are available for sale, but buyers are limited. Those that have secured interest (typically from end-users or insurance companies) are stuck in an extended due-diligence process. Only discounts of around 40% to 50% peak values are being entertained.

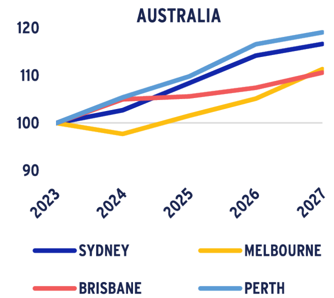
SOUTH KOREA: RENT CYCLE PEAKING, STRATEGIC INVESTORS SUPPORT PRICING

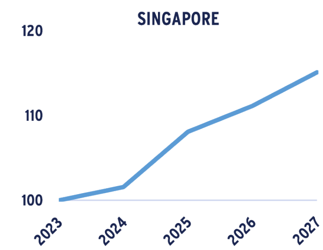
- Limited supply in the next three years in the three core markets ensures a landlord favorable environment should continue. However, concerns about affordability and limited room for further incentive adjustments will taper future rental growth.
- South Korea's office market has defied expectations of downward price pressure to-date, thanks to investment activity by strategic investors who continue to bid up on pricing. We expect strategic investors to continue to be active, meanwhile, foreign investors are certainly interested, but given debt levels, would likely only transact at higher yields.

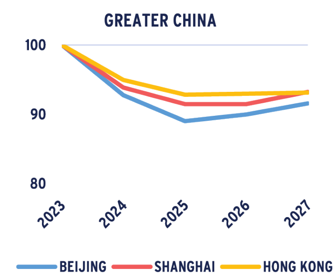
JAPAN: SUPPLY RISKS CONTROLLED WITH MODERATE TENANT DEMAND

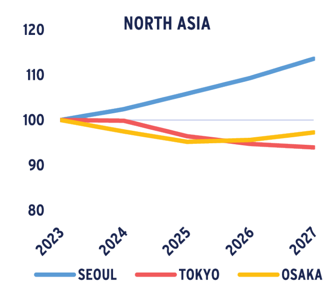
- Recovering demand has mitigated the impact of 2023's surge in completions. However, a subsequent increase in supply in 2025 is expected to keep vacancy rates above historical averages throughout the forecast period and rental weakness is likely to resume in 2025.
- Investment volumes in Tokyo have come down, but ostensibly held up better than other markets. We expect investors to continue to be selective on assets, Grade B is likely to see more liquidity as the number of Grade A offices for sale stay limited.

OFFICE RENT INDEX
2023=100









Source: AEW Research, JLL, Q4 2023

Logistics

AUSTRALIA: DEMAND SLOWS BUT VACANCY TO REMAIN LOW

- New construction peaks in 2024 and 2025 are expected to be met with slower demand (hampered by cost pressures and economic uncertainty). Pre-lease for 2024's supply is around 40%, markedly below the past five-year average.
- Investment activity has rebased to long-term historical average volumes, after surges in 2021 and 2022. Overall investors will likely remain interested in the asset class and with lease reversions still in the range of 30 to 40%, short WALE assets are trading at tighter yields. For long WALE assets, yields have expanded around 100-125 bps since year-end 2022. A gradual compression trend is only likely in 2025.

SINGAPORE: FAVORABLE OCCUPIER CONDITIONS, MORE INVESTORS TARGET THE SECTOR

- Favorable fundamentals persist for prime logistics with limited vacancy in modern facilities. Rents grew by around 15% in 2023 (as expected) with projections of tapering growth (between 3% to 5% growth in 2024 and 2025) as demand has mostly peaked. The sector continues to be actively traded driven by attractive yield spreads (to cost of debt) and the optimistic rental outlook.
- Conversely, the leasing in business parks and high-tech space has turned challenging with vacancies and shadow space in eastern and western submarkets increasing which will result in rental declines in the near-term.

HONG KONG: VACANCY REMAINS LOW, BUT DEMAND HEADWINDS INCREASE

- While warehouse vacancy remains low, rents are expected to level off and face potential declines in 2024. Many lease renewals are due in 2024 and given that they were originally signed during the market rebound in 2021, we expect downsizing and more surrender space, especially for cold-storage space.
- Liquidity is restricted given where interest rates sit, with overall transaction volumes in 2023 down close to 60% year-over-year. Of note, was the activity for self-storage use, through both enbloc and smaller units /whole floor transactions.

SOUTH KOREA: CONSTRUCTION AND SUPPLY CHALLENGES BRING OPPORTUNITY

- New supply in 2023 peaked while demand has stayed relatively healthy.
- Cold storage space is still oversupplied, and rent reductions, concessions or conversion to other use such as dry storage or even data centers are options being looked at by landlords to maintain occupancy and returns.
- Several opportunities are emerging; the ongoing construction delays, cancellations and permit rejections are lowering supply risks and giving the market time to absorb new completions and feeding into the theory of market stabilization by early 2025. At the same time, there is a growing pool of distressed opportunities set to become available from developers who are unable to service high-interest bridge loans on their project financing. AEW research understands that some of these developers are already in default.

JAPAN: BETTER CONDITIONS IN INNER-CITY LOCALE, INVESTMENT ACTIVITY TO MODERATE

- Occupier conditions are bifurcated by location. Near-city areas with good port access see limited construction and rent increases, while farther inland markets face heavy leasing competition with large new construction.
- The logistics market was keenly sought after by investors in 2023 with investment volumes increasing by around 16% year-over-year. Interest is expected to moderate in 2024, especially with impending changes in monetary policy by the BOJ compressing cash-on-cash returns.

LOGISTICS RENT INDEX
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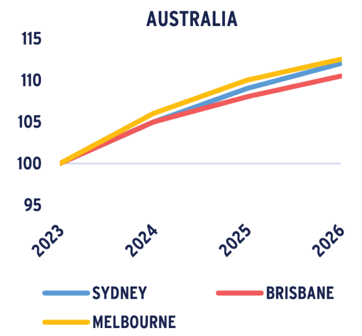
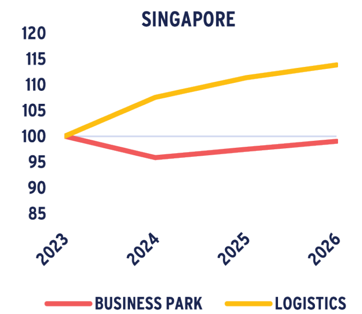
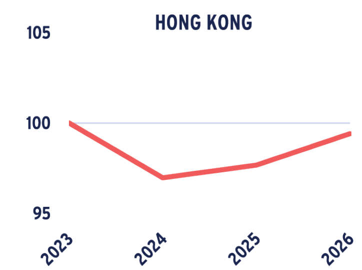
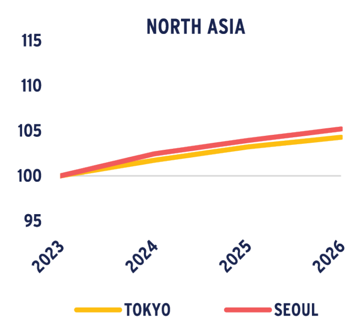








Source: AEW Research, JLL, as of Q4 2023

Retail

AUSTRALIA: RETAIL SALES STRONG UP TO Q4, POSITIVE YIELD SPREADS

- November 2023 retail sales were healthy, increasing by 2.2% year-over-year – a largely expected outcome as buyers took advantage of attractive sales and discounts during the festive season. However, retail sales for December dropped during the same period despite aids from population growth and inflation. This has added to a weak outlook for retail sales in 2024, alongside economic fundamentals.
- Yet, now, the retail sector is probably performing at its best in the last few years. Average leasing spreads have turned positive for major landlords and occupancy costs for retailers have decreased, allowing more latitude for expansion demand. At the same time, supply going forward is constrained.
- Retail yields have widened gradually since 2017 and today the asset class presents great value. Yields are comparable to where they sat in the early 2000s for sub-regional and regional malls.
- Accordingly, private capital has taken an interest in the sector this year, with investment volumes increasingly in Q4. Bulk of buyers to-date have been domestic but foreign players are likely to make moves soon.

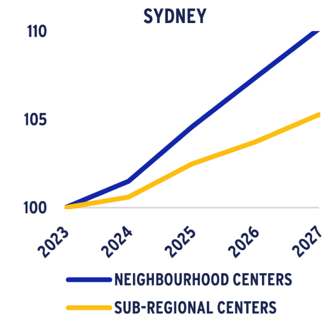
SINGAPORE: VACANCY DROPS TO LOWEST LEVEL SINCE 2013

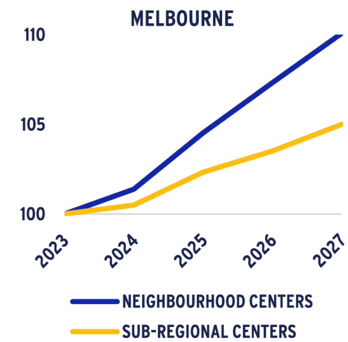
- Retail sales in Singapore have been easing for the last four months of 2023, but major landlords continue to report healthy in-store sales and foot traffic. New-entrant demand was a major leasing driver and vacancy rates even declined in Q4. Across suburban malls and in the prime areas of Orchard Road, vacancy rates today at 1.1% and 1.5% respectively, are their lowest level since 2013.
- The last few months of 2023 and early weeks of 2024 have seen a revival in large shopping center sales. Some of these sales were related party transactions while others involved private capital buyers with pricing staying consistent so far.

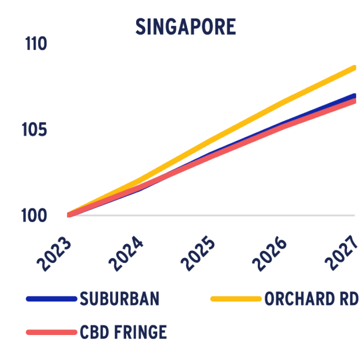
HONG KONG: TOURISM-LED RECOVERY, BUT FOCUS ON SERVICES

- The retail market continued to recover up to Q4 2023, but in terms of volumes, still hovers at around 85% of pre-pandemic levels.
- Further recovery in the sector is hampered by a leakage in domestic spending through outbound travel. Southern Chinese markets like Shenzhen are benefiting from a reverse travel pattern, where more Hong Kongers are traveling northbound to shop at megastores like Sam's Club and Costco where better discounts are available and the Hong Kong dollar (pegged to the USD) can be stretched further. At the same time, inbound tourists from mainland China are spending less on goods and more on services.
- Prime retail centers are under pressure after a record number of new completions in 2023, followed by further supply due in 2024. The make-up of high street retail is altering, with units being leased at major discounts to mass market retail or eateries.
- Domestic, non-institutional investors continue to comprise the bulk of capital interested in the sector, especially for high-street shops where there is attractive value.

RETAIL RENT INDEX
2023=100







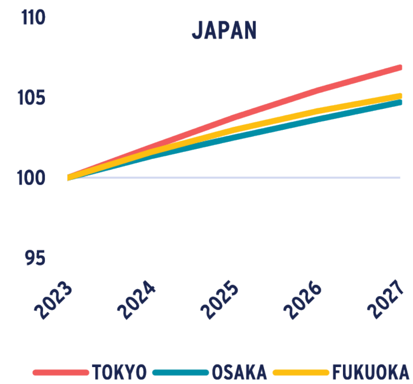
Source: JLL, as of Q4 2023

Multifamily

JAPAN: HEALTHY DEMAND, RENT GROWTH TO SUPPORT CAPITAL VALUE GROWTH

- Migration patterns have already returned to pre-pandemic levels, supporting the demand in major cities. A greater rate of in-office attendance, especially in H2 2023 has supported a net migration return to Tokyo 23 Wards
- Leasing conditions, especially in inner-city areas, have improved compared to one year ago, and there is a resurgence in demand for units in areas easily accessible to CBD locations.
- The premium the Central 5 Wards which dropped to 18% over 2021 and 2022 has now increased to >20% and is expected to increase over 2024. Wage growth, which is finally evident in Japan, will further support rental increases while high-income professionals will be inclined to live closer to their workplaces in the central areas.
- Capital remains interested in the sector, and yields should remain stable despite the expectation for an increase in interest rates. Rental growth in the near-term will contribute to capital value increases.

MULTIFAMILY RENT INDEX 2023=100



Source: PMA, as of Q4 2023