AEW RESEARCH | ASIA PACIFIC

The Residential Potential

Asia Pacific: An expanding investable market

NOVEMBER 2021

Asia Pacific's multifamily sector is set to expand and is piquing the interest of investors. The three markets of most interest are Japan, Australia and China. Japan is a proven multifamily market with deep institutional ownership and transaction liquidity. Australia and China are two markets that are emerging based on favorable demographic trends and policy support.

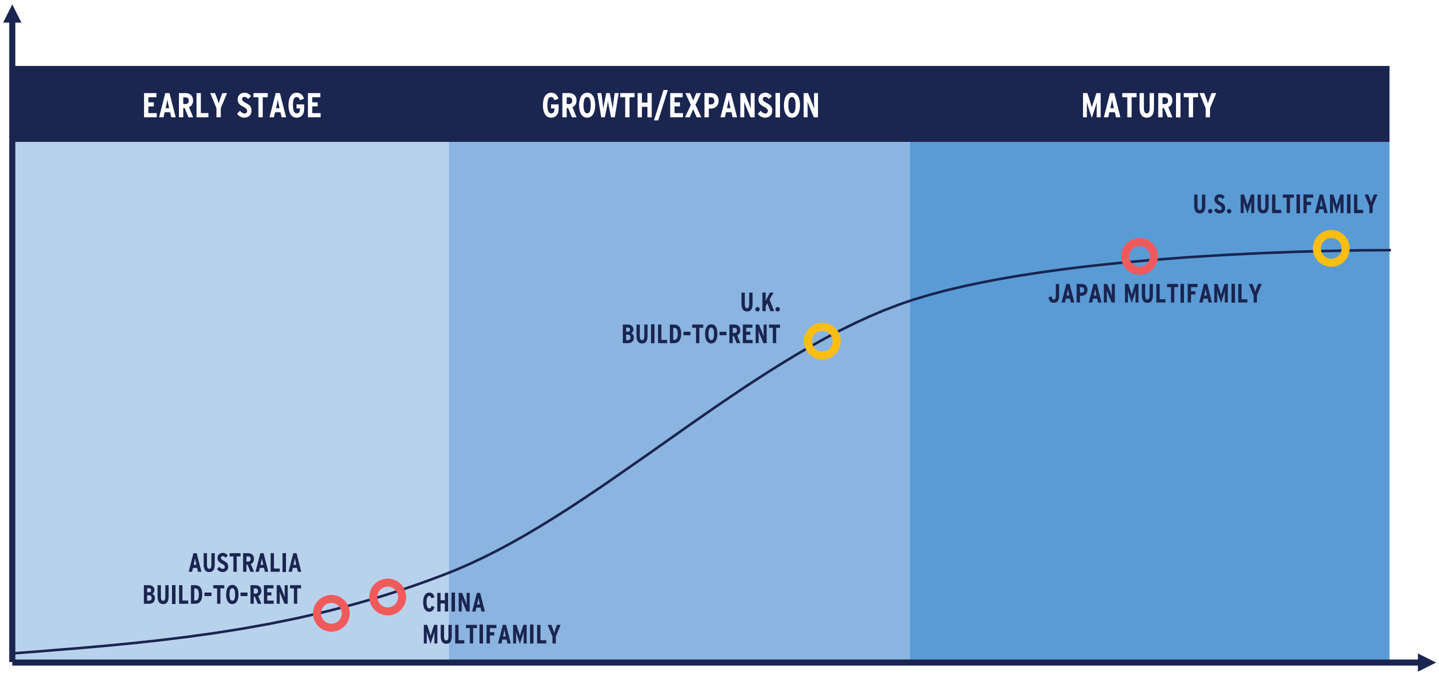
Multifamily assets provide an opportunity to increase a portfolio's recurring income through stable rents and necessity-based demand. Rents have shown a high correlation to wage growth and multifamily income has proved less cyclical than other sectors over time. The most recent recession has reaffirmed this profile.

Investors have shown confidence in the defensive characteristics of multifamily by increasing their allocations. As of end 2020, multifamily was the second largest sector in real estate portfolios for global institutional investors, second only to office.

The structural factors underpinning the sector are similar across Japan, Australia and China:

1) Urban migration and population growth where housing provision is insufficient;
2) Strong increase in home prices that have constrained purchasing affordability and made renting more accessible; and
3) Renting has become a more relevant choice due to lifestyle changes of a younger generation.

Due to various stages of the sector's maturity in each market, the typical investment style and risk/return profiles are varied. In this research paper, we revisit the structural features and fundamentals of Japan's multifamily sector and peek into the emerging opportunities and investment drivers for the sector in Australia and China.



Source: AEW Research

Japan Multifamily

Renting in Japan has been influenced by several factors, some of which have intensified in recent years. Strong growth in residential prices has made buying a home unaffordable for many, especially in the larger cities. At the same time, renting offers flexibility in movement and lifestyle which are increasing priorities for the younger generation. Overlaying these with the fundamentals of housing demand and supply, AEW Research presents several investment considerations and favorable principles for investing in Japan multifamily.

JAPAN MULTIFAMILY

USD 7.2 billion of liquidity p.a.

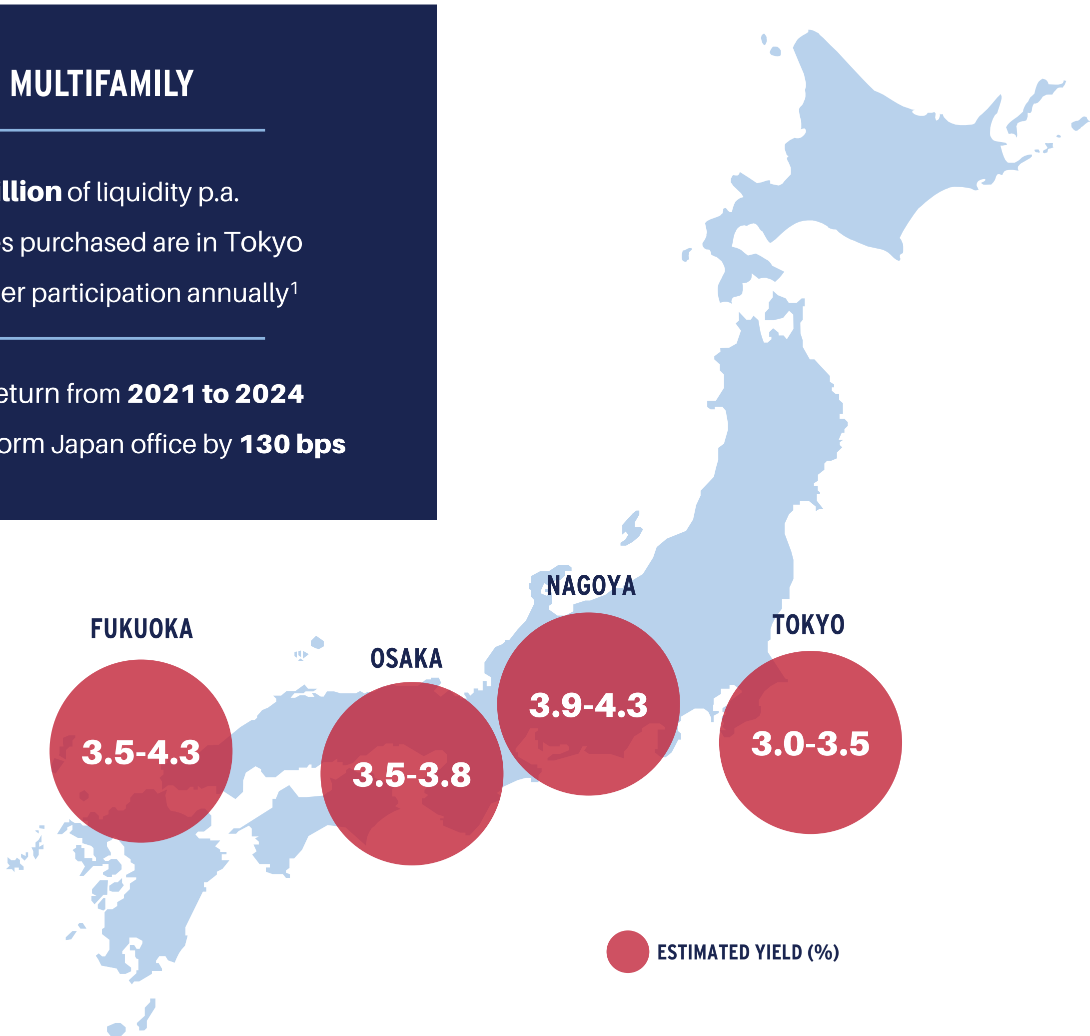
60% of properties purchased are in Tokyo

45% cross-border participation annually[1]

5.9% p.a. total return from **2021 to 2024**

Expected to outperform Japan office by **130 bps**

[1] As calculated from 2018 to August 2021



Sources: AEW Research, RCA, JLL

The Key Fundamentals

- **Bigger cities, larger rental market** Renting is prevalent in bigger cities and within younger age groups. In Tokyo, Osaka, Nagoya and Fukuoka the pool of potential renters is high, as more than 40% of residents are below the age of 40.
- **Mid-market residential sweet spot** Small units (25-44 sqm) typically cater to middle income earners who prioritize urban living and commuting convenience. Demand was high from 2015 to 2019 and is expected to return going forward as cities continue to attract young migrants and experience a decline in average household size.
- **Importance of location** A neighborhood's attractiveness is backed by its proximity to train stations, travel times to employment nodes and surrounding retail amenities. Uneven population growth within cities is a byproduct of this as some areas prove more popular. From 2020 to 2030, 56% of the wards in Tokyo and 25% in Osaka will see population growth, and as a result, assets in these locations will see better rental demand.

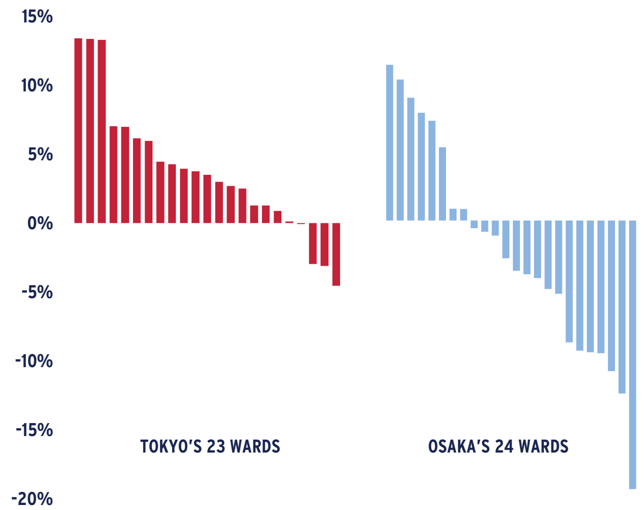
Income Stability is a Major Feature

- **A defensive and resilient sector** In the 2009 crisis, multifamily rents fell by 10%, compared to a 40% decline in office rents. This resilience is being replayed today as multifamily rents have not had a widespread drop while office has declined by more than 10% from its peak in 2020.
- **Leases are backed by a rent guarantor system** Rent guarantor companies work closely with property owners to provide an added layer of protection to rent collection. They perform credit/background checks on potential tenants and guarantee their rental payments for the duration of the lease.
- **Unique employment contracts** Dismissal of workers is regulated in Japan which ultimately makes it difficult to retrench or cut jobs. This added level of security to paychecks has also been helpful in underpinning the income stability of the residential sector.

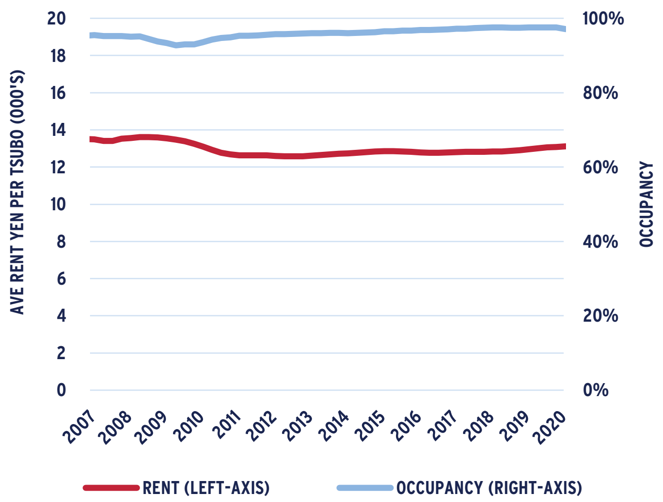
Favorable Future Trends

- **Gradual decline in new supply, especially smaller units** Housing construction is expected to slow due to COVID-related delays and a rise in the cost of raw materials. This will be supportive to rental growth. New builds are also increasingly scrutinized by local governments who are recommending a floor on the minimum unit size.
- **Return of migration in 2022** Internal migration to cities fell in 2020/21, but a return is expected in 2022, contributing to new housing demand. While migration is likely to resurface, it may take some time for the pace of population growth to reach previous years' levels.
- **Room for yield compression** The low interest rate environment lends support to income return, especially in a lower-for-longer environment. With substantial investor interest, we expect continued yield compression to generate capital gains. Further, with multifamily yields in Europe and the U.S. about 50bps below office, this indicates potential for further compression for Japan multifamily.

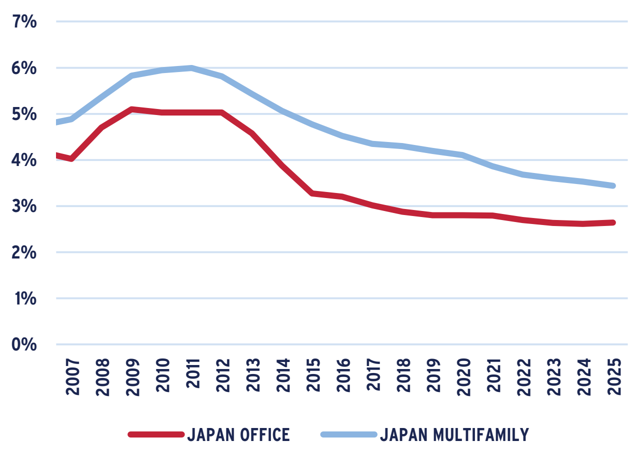
POPULATION GROWTH BY WARD - TOKYO AND OSAKA 2020 TO 2030



TOKYO 23 WARDS AVERAGE RENT AND OCCUPANCY



JAPAN OFFICE AND MULTIFAMILY YIELD 2007 TO 2025F



Sources: AEW Research, National Institute of Population and Social Security Research, ARES Japan, JLL and PMA

Australia Build-to-Rent

Build-to-Rent (BTR) is a developing institutional asset class in Australia and is being viewed as a new income-returning investment. It refers to a segment within privately owned residential which has been constructed for renting rather than sale. It is typically owned by institutional investors and managed by specialist operators with a service-driven model. The sector gained traction in the U.K. from 2010 and is now in its nascent stages of development in Australia.

For AEW, the best BTR projects are large-scale developments (100 to 400 units), with multiple shared amenities offering value-add services like concierge, resident events, 24-hour security and in some cases, ground-level retail. BTR's services are usually tailored based on the location and target demographic.

For now, most active foreign investors are gaining access through joint ventures (JVs) with local developers or investing in BTR funds. However, participation has been fairly limited as BTR is not eligible for the reduced Managed Investment Trust (MIT) withholding tax rate, which does apply for foreign investors in other commercial sectors.

There is a healthy pipeline of BTR projects under construction, mostly funded through domestic capital. While there are still a lot of unknowns for the product in terms of after-tax returns, proven exit and supportive policy, the positive experience in the U.K. and the U.S. is promising. These offshore markets have provided valuable know-how and insights in creating a successful product and reaffirms the growing demand and need for BTR.

AUSTRALIA BUILD-TO-RENT

AUD100 billion opportunity

About **75%** of **capital invested to-date are domestic**

An estimated **14,000 units** to be supplied up to 2027

Sources: JLL, CBRE, EY

The Case for BTR in Australia

- **Acute housing shortage** Prior to 2020, housing was undersupplied by close to 80,000 units. As construction starts fell dramatically through the pandemic, the housing balance is expected to further skew when borders reopen in 2022. Building approvals in the 12 months to July 2021 were down by 40% in Victoria and 16% in New South Wales, compared to the previous three-year average.
- **Population growth & demand for urban housing** Overseas net migration accounts for 60% of Australia's population growth, with Sydney and Melbourne as prime beneficiaries. Migrants show a tendency to settle in major urban areas due to better employment opportunities, so when overseas migration resumes, the expectation is for a surge in housing demand in inner city locations. By 2024, more than 75% of overseas migrants are expected to stay within 30 km of CBDs in NSW and VIC.
- **Growing appetite for rental housing** Renter households in Australia have grown by about 50% in the last 20 years, now making up 32% of the population. While part of this shift is explained by changing desires and social practices of a younger demographic, it is also reflective of housing affordability issues. House prices have increased by 15% to 25% in Sydney and Melbourne over the last three years, and the country now has one of the highest house price-to-income ratios globally.

Sizing the Opportunity

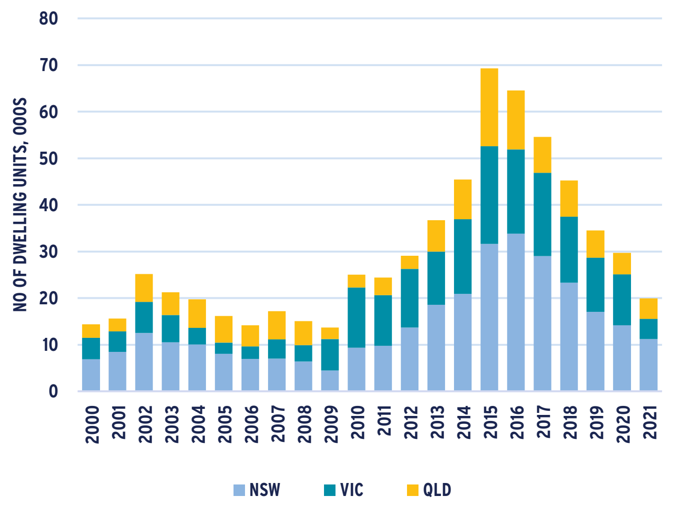
- **More than 400k units needed up to 2030** At the moment, there are about 14,000 BTR units in the pipeline completing from now to 2027. Based on housing demand forecasts, another 400,000 rental units are needed to fill demand by 2030, indicating a significant scalable opportunity for the sector.
- **Potential for growth** U.K.'s BTR market flourished post 2010, and as of end 2020, made up about 2% of rental housing stock, worth about GBP70 billion. The private rental market in Australia today represents about 20% of the overall stock. By granting BTR a MIT status and classifying it as a commercial asset, by 2030, it could comprise about 5% of rental stock, worth about A$100 billion.[2]
- **Rental premium and growth** The offshore BTR experience is laying a promising path. In the U.K., recent surveys have confirmed occupiers are willing to pay more for the services and amenities, with BTR achieving a rental premium >10% compared to the overall rental market. It also showed the sector maintained healthy vacancy rates circa 5% and generally saw rental growth in line with inflation.

[2] Based on an estimate by EY

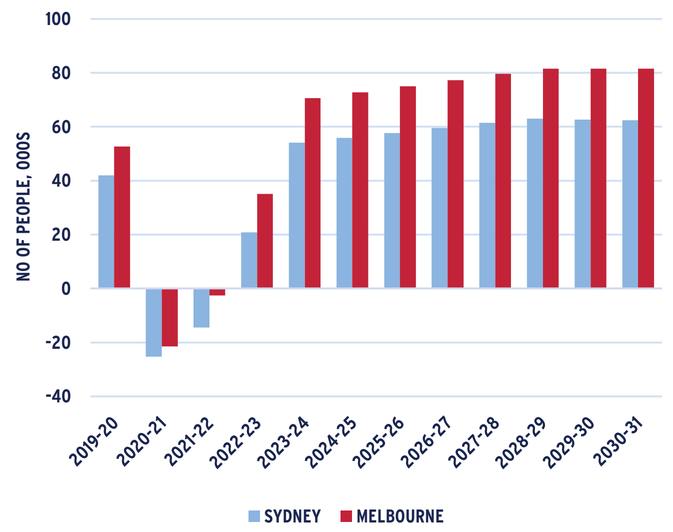
Going Forward

- **More tax and policy reform needed** BTR has the scope to become a meaningful investment for domestic and foreign players. Still, significant improvements on policy, taxation, and a more streamlined development approval process are required to draw capital to the sector. Some institutions are waiting for clarity from federal and state governments regarding land tax regulations before starting construction on their projects.
- **Positive metrics in the near-term** Because of the positive underlying fundamentals, rent growth prospects will be high after borders reopen. Annual rent growth could be in the range of 3 to 4% p.a. for the two years ending in 2024. Beyond that, rental growth should fall in line with inflation. With rent growth, scale and supportive policy, we expect the sector to see healthy cap rate compression in the next five years.

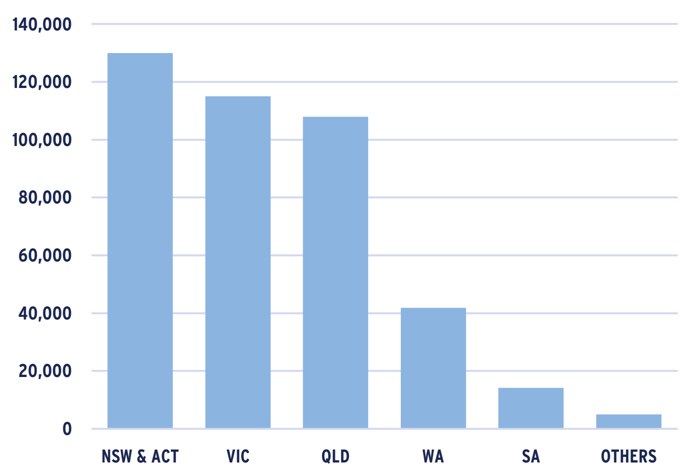
HIGH DENSITY DWELLING BUILDING APPROVALS
2000 TO JULY 2021



SYDNEY AND MELBOURNE NET OVERSEAS MIGRATION
2019 TO 2030F



DEMAND FOR RENTAL UNITS BY STATE
BY 2030



Sources: ABS, Center for Population, PCA

China Multifamily

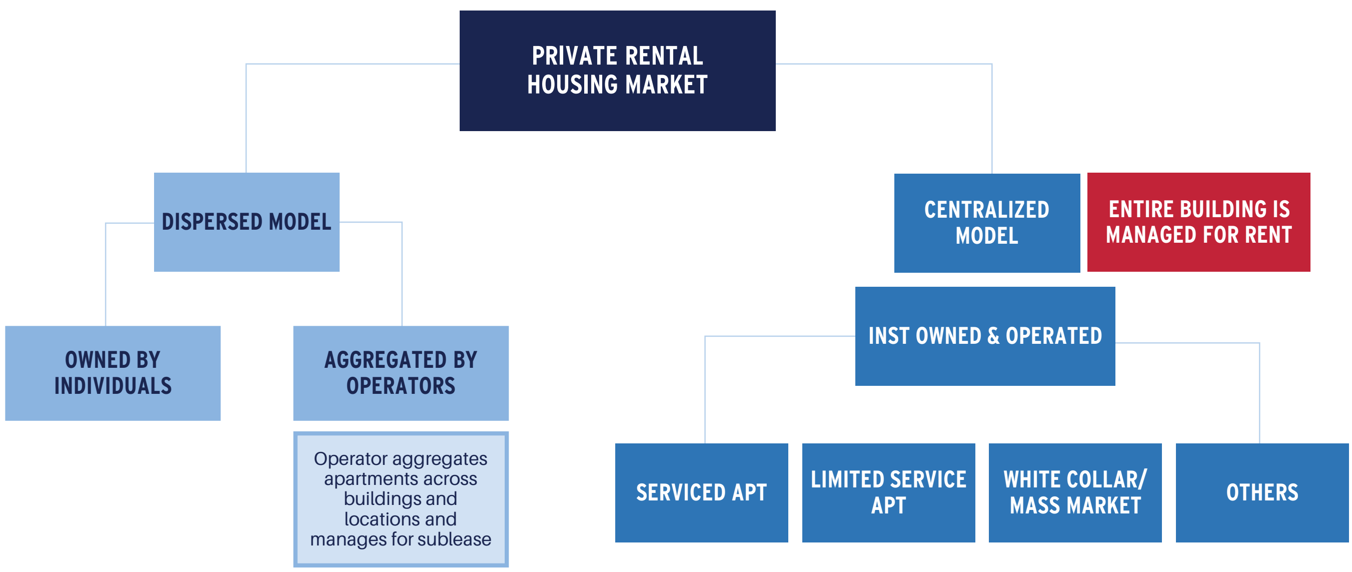
China's rental housing market is transforming on the back of government support, new and diverse sources of demand and strong interest from investors and developers. In the two years ending 2022, the country's renter population is expected to grow by 20 million, presenting a sizable opportunity.

While the population of renters has increased, homeownership remains a mark of success for most Chinese and often, a precursor to marriage. But because more individuals are delaying marriage, the proportion of renters between ages 25 to 35 years are expanding.

The best demand fundamentals are in the Tier 1 cities where the rental housing sector has been a beneficiary of urban migration, an increasing number of young graduates (who are known to have high mobility), and rising cost of homes.

China's centrally managed private rental housing market covers a broad spectrum of residential offerings and can be broadly split into serviced apartments, co-living, mass-market housing, blue collar housing and in some cases student accommodation (see figure below). Private capital to-date has mostly been interested in the serviced, limited-service and mass market apartments. Unit sizes range widely, but the sweet spot is typically 25 to 35 sqm and a typical lease term is between six months to one year.

Policy has played an important role in supporting the sector's growth so far. However, because it is a social tool utilized by the government to manage the country's urban housing problem, the sector is also vulnerable to policy intervention. Accordingly, investors need to be aware and prepared for such policy risks and uncertainties.



Why Now?

- **Together with policy** The government is encouraging private and public investment to grow the rental housing market in China through supportive policy. These include supply-side reforms like development incentives, tax breaks, reserving land sites in urban locations for rental homes and streamlining approval procedures. In some cities, new rules have also addressed tenants' rights, tax incentives and local governments have also allowed renters to apply for residency, which was previously not allowed.
- **The need for urban rejuvenation** The dual impact of 1) the government's clamp down on the property sector; and 2) COVID-19 disruption has created several underutilized assets in sectors like hotel, retail podiums and Grade B offices that could be acquired at attractive discounts. Local governments are encouraging undermaintained assets to be converted to rental housing.
- **Increasing and diverse renter group** The renter population is expected to grow by 20 million from 2020 to 2022, on the back of affordability constraints and a change in lifestyle choices. The primary source of rental housing demand has come from fresh graduates, but in recent years, other demand sources like senior professionals, small business owners and young families have increased, meaning there is growing acceptance of renting in China.

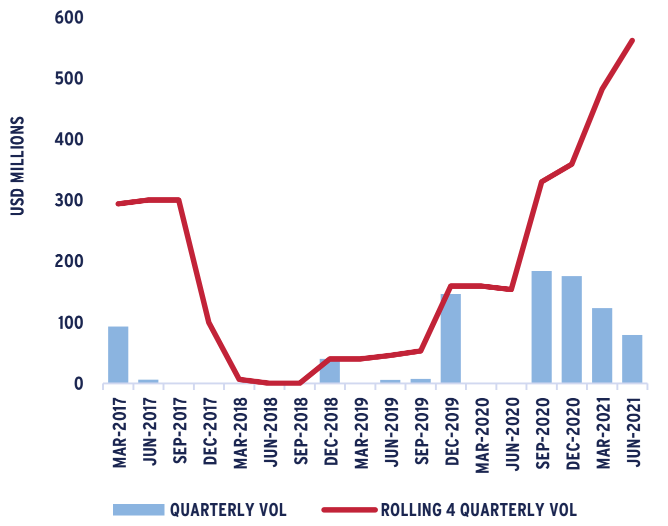
The Opportunity

- **Convert to use** Converting underutilized commercial properties to multifamily has proven successful and is a preferred route for foreign capital to-date. Success has been seen through the asset-heavy model, where investors formed JVs with Chinese developers or experienced residential operators. In the past, operators would typically master lease a building, but more are opting for a revenue sharing model today to balance out the leasing risk.
- **Acquiring Land** Land designated for rental housing (R4) has been popular with SOEs and domestic developers. These sites are heavily discounted and often come with rules on rent ceilings and apartment size guidelines. While R4 sites typically have sale/transfer restrictions, some institutional investors are taking on the risk and trying to gain access by forming funds or club structures with domestic developers.
- **Rental premium with option for additional income** Mass market apartments offer convenient options for young graduates and office workers. Meanwhile, at the higher end of the market are serviced and limited-service apartments in urban locations that target mid-to senior-level local and expatriate professionals. Through this, there are options to expand income streams by offering other value-add services like laundry, entertainment and childcare.

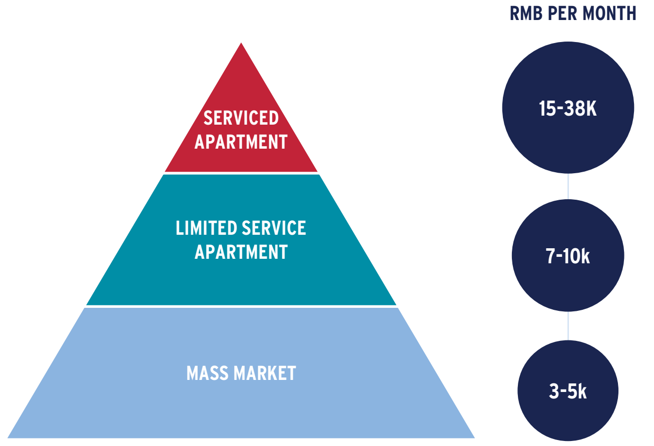
Going Forward

- **Positive metrics** The industry is still developing, but there are already a few positive rent metrics. Multifamily is estimated to have a 15% to 20% rental premium compared to traditional rental apartments. In the past year, many projects saw rent growth of up to 10% indicating pent-up demand for the product. At the same time, with greater acceptance of smaller living spaces with community facilities, landlords could see significant rental premium on a per square meter basis.
- **Future exit routes** Authorities are promoting the securitization of rental housing assets, which will create a potential exit for developers and investors in the sector. It is likely that the first few residential REIT listings will be from SOE-backed developers, and it will take some time before private investors can benefit. Nevertheless, the securitization helps to increase the efficiency of capital and transparency in the sector.

RESIDENTIAL/MULTIFAMILY INVESTMENT 2017 TO 2021



RENTAL HOUSING TYPES AND ESTIMATED RENT SHANGHAI



Sources: AEW Investments, Real Capital Analytics
* To be taken for reference

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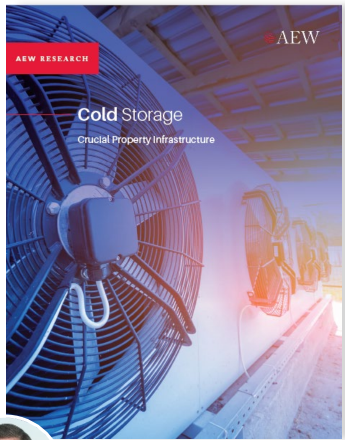

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