AEW Research

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WHY WE KEEP SEOUL SEARCHING

Seoul's office market was one of the few in the Asia Pacific region that stayed resilient in 2020. The occupier market remained healthy, investor interest was high, and the city recorded better than expected transaction volumes. But why? Here we take a closer look at the inherent features of the Seoul office market that led to this result, the attractive fundamentals and key opportunities, and what we might expect to see going forward.

AEW analyzed the historical performance of the Seoul office market and compared it to other cities across the Asia Pacific region. Our research found the sector has several key attributes: stability, affordability and liquidity. Seoul office rents are the most stable in the Asia Pacific region, current pricing is not overly stretched, and its capital market benefits from a deep institutional domestic investor base, as well as active cross border capital.

The three core business districts (CBD, Gangnam and Yeouido) present opportunities across the risk spectrum. In addition, several emerging business districts are reaching the radar of investors due to a relaxation of sales restrictions and solid occupier fundamentals.

From a regional portfolio perspective, adding Seoul to a diversified Asia Pacific office portfolio reduces the volatility by more than 20% and increases the return per unit of risk from 1.9 to 2.3. The growing listed REIT market will also expand the overall market liquidity and contribute to increased transparency and capital value growth in the long-term.

STABLE RENTS OVER TIME

- **Most stable rental market in the region:** Across developed office markets in Asia Pacific, Seoul's three core business districts have had the lowest rental volatility for the past 15 years, making it attractive for investors seeking stable income returns.
- **Limited market downside:** Seoul's rental cycles are short and mild. As a result, the market has seen a steady increase in rents over the last ten years. For periods where the rental market has corrected; i.e., in 2009 (GFC) , 2013 and 2017, annual declines were minor and did not exceed 3%. This contrasts with other markets in the region which had more pronounced and extended cycles.
- **Rental cycle less sensitive to vacancy rates:** Rental movements across Seoul's three core office markets seem to be less predicated on vacancy levels than other cities. Since post-GFC, our analysis across the region shows that Seoul has had an extremely low correlation between vacancy rate and the underlying rental growth. On average across the three core markets, a +1 percentage-point change in vacancy results in only 0.07% reduction in rents.

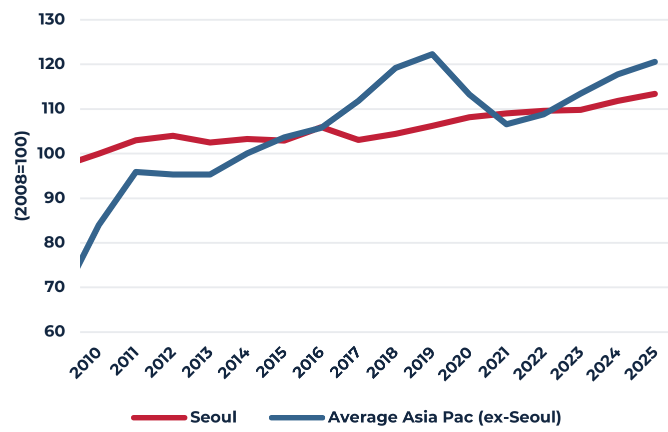
AFFORDABLE AND ACCESSIBLE

- **Capital values only slightly above GFC peak:** Unlike other gateway cities in the region, current capital values in Seoul are only slightly above previous GFC peaks and have grown in-line with the local economy. As a result, values look relatively attractive to historical trends (see AEW's previous analysis on capital values: "*Pricing of Office Markets in Asia Pacific"* June 2020, www.aew.com).
- **Spreads are still attractive:** The spread between real estate yields and the risk-free rate are at 240 bps as of Q4 2020 and higher than the long-term historical average of 190 bps.
- **Liquidity is a key feature of the office market:** Many distinct buyer and seller groups in Seoul have helped to establish a deep and diverse transaction market. In the past couple of years, seller groups have ranged from investment managers (with funds nearing end of life), developers, pension funds and insurance companies. Additionally, an active domestic buyer market deepens exit options.

VARIED OPPORTUNITIES IN THE MATURE SUBMARKETS

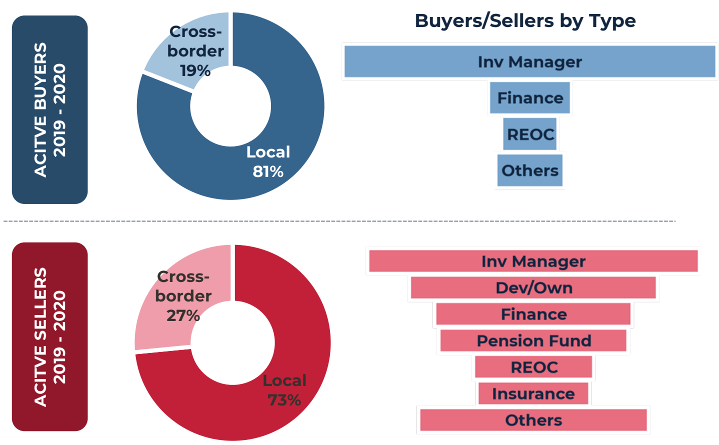
- **Established submarkets with distinct occupier groups:** The core office markets are well established, with some occupier clustering (CBD – multinationals and conglomerates; GBD: technology hub; YBD: financial hub). Because of this, leasing drivers tend to be distinct, generally making demand fundamentals more predictable.
- **"Aging core" presents value-add opportunities:** Business districts started to form from the 1960s and 1970s and as a result, a large proportion of stock is dated, presenting opportunities to rejuvenate and reposition for modern use. The bulk of this is in the CBD which has the largest volume of Grade B stock. Further, in a post-COVID world, the need for improved space utilization/varied workspace configurations, as well as enhanced hygiene measures might warrant further upgrades. Besides capex spending, other ways of repositioning as core include creating long WALEs and bringing in creditworthy tenants.
- **Active core markets:** Core and core-plus buyers have been active in Seoul's office markets, reflecting the quality of recent construction. About 66% of Grade A buildings constructed since 2010 have exchanged hands to-date.

OFFICE RENTAL INDEX 2010 to 2025F



Sources: JLL

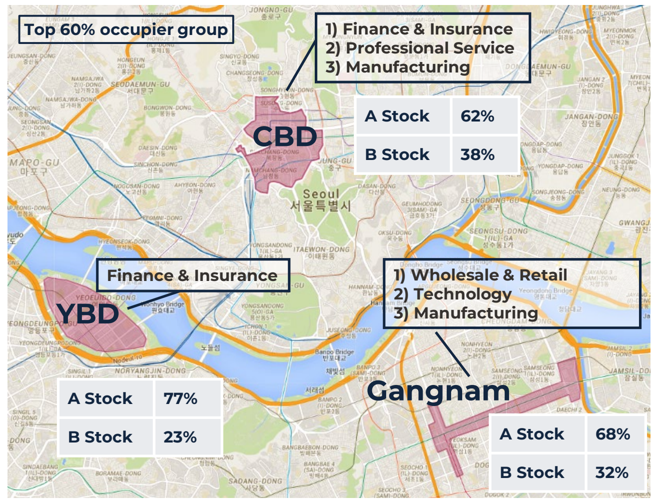
YIELD SPREAD AND MARKET PARTICIPANTS



Market	CBD	Gangnam	Yeouido
Current Yield Spread	2.0 – 2.5%	2.0 – 2.2%	2.5 – 2.8%

Sources: RCA, Oxford Economics, AEW Research

SEOUL'S ESTABLISHED OFFICE CLUSTERS



Sources: JLL, RCA, AEW Research

NEW OPPORTUNITIES EMERGING

- **Expanding investable opportunities:** Beyond the traditional business districts, there is an estimated 4 to 5 million square meters of office stock spread across emerging locations like Pangyo Techno Valley (PTV), Bundang, Magok and Digital Media City (DMC) in Mapo-gu. In particular, PTV and Bundang are of scale with suitable transport networks and amenity to ensure its occupier appeal and are opening up as suitable options for institutional investors.
- **Excellent fundamentals in some emerging markets:** PTV and Bundang are at close to full occupancy. Limited supply and pent-up demand will provide conditions for strong rental growth in the near-term.
- **Relaxing restrictions in PTV creates opportunities:** The ten-year sales moratorium for assets in PTV Phase 1 are gradually expiring, creating new investment opportunities. Buildings in PTV2 (expected to fully complete by 2023) continue to have sales restrictions but are expected to be shortened to five years.
- **More insurance firms to sell down assets:** More insurance companies are due to sell off assets on their balance sheets. As several assets in core locations have already been divested, there is an expectation that they will move to sell down some smaller- to mid-sized assets owned outside of the traditional business districts.

WHY AEW BELIEVES SEOUL OFFICE WILL REMAIN IN FAVOR

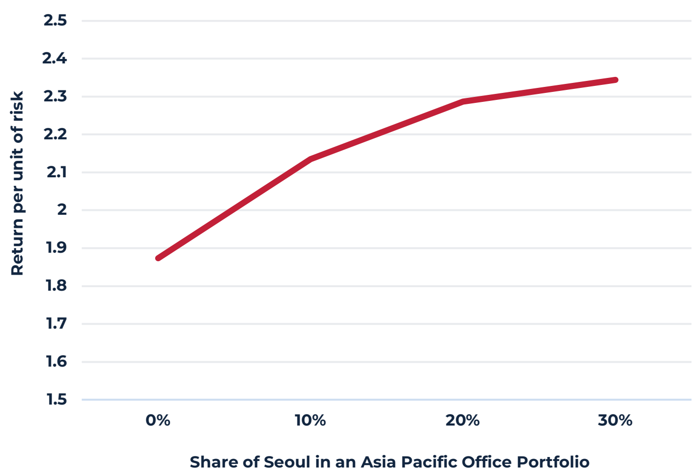
- **Benefits to a diversified portfolio:** Seoul's stable rents and income, in addition to a diversified regional portfolio, reduces the overall portfolio volatility, providing higher risk-adjusted returns.
- **More room for foreign capital moving forward:** In recent years, Seoul's transaction market has been dominated by domestic capital who have aggressively chased investments in core and development projects. Towards the end of 2020, more local groups have started to shift focus to overseas markets, predominately for the purposes of portfolio diversification. We expect this trend to continue into 2021, paving the way for more active foreign participation.
- **Increasingly institutionalized:** More REIT listings in the Korean market over the next few years will increase market transparency and aid in capital appreciation over the long-term.

SUMMARY OF EMERGING MARKETS

	Pangyo Techno Valley	Bundang	Magok
Development Stage	Development started in 2009 and by 2024, market size will be 2.7 m sqm (incl. Phase 2 and Phase 3). Bulk of new stock will complete in 2023	Developed in the 1990s to capture spillover demand from Gangnam	Maturing submarket, still under development
Office Type	Campus style, office buildings with well-developed transport infrastructure & amenities	Mostly aged and smaller-sized, strata-titled office buildings	Bulk of stock is owner-occupied
Rent	Ave. 40% discount to the three core markets	Ave. 50% discount to the three core markets	NA (few third-party leases)
Typical Occupiers	PTV 1: Info & bio-tech PTV2: Automobiles & big data PTV3: Fintech, blockchain	Technology firms	Biotech, mostly domestic conglomerates

Sources: JLL, PMA, AEW Research

ADDING SEOUL TO A DIVERSIFIED ASIA PACIFIC OFFICE PORTFOLIO



Note: Results are determined from historical total returns across developed Asia Pacific office markets from 2011 to 2020
Source: AEW Research, JLL

Please do contact us if you would like to learn more about our analyses of the property markets in the Asia Pacific region

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