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Savills World Research
Singapore

Asian Cities Report
Singapore Investment

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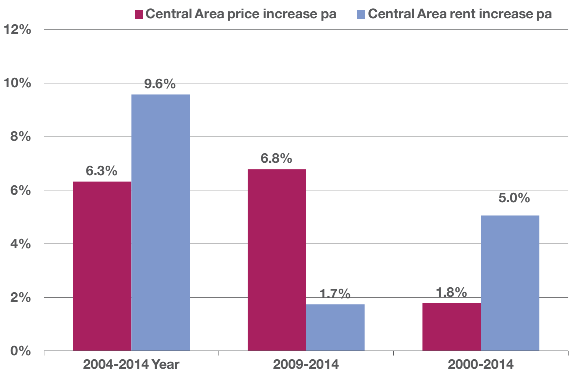
GRAPH 1

Rising trend of CBD Grade A office prices and rents, Q1/2004–Q2/2014

Source: Savills Research & Consultancy

GRAPH 2

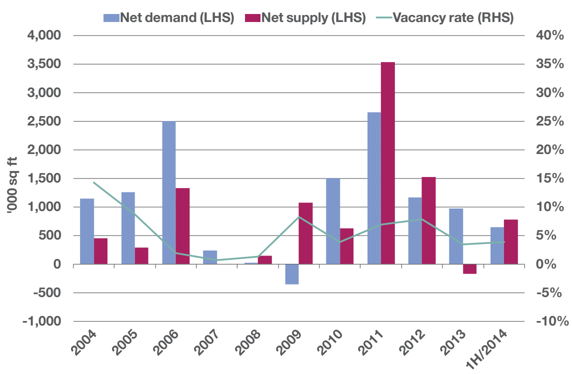
Price and rental increase per annum since 2000 - comparing varous periods



Source: URA

GRAPH 3

Net demand and supply of Grade A CBD office space, 2004–1H/2014



Source: Savills Research & Consultancy

What drives Singapore's investment real estate?

Investment in real estate is usually defined as taking a long term position in physical property for the purpose of reaping rental income during the holding period and capital gains at the end of that period. Although the investment decisions may appear rather intuitively straightforward for many, that is perhaps only for the individuals or those engage in crowd funding where the investment quantum is rather small and thus the decision making process need not jump through too many hoops. However, for institutional investors, their decision making is process driven. Not only must the financial returns meet their expectations, but due diligence on the physical building plays an important role as well. In this piece, we will look at investment decisions taken by institutions and the focus will be on office developments.

For the majority of institutional funds, their focus is usually on income generating properties. That means the real estate is completed. Most do not have the mandate or much latitude to invest in properties under development. This is because many of the funds are derived ultimately from pension bodies which adopt a lower risk profile and have the need to achieve an actuarial return target by certain dates.

Owing to the need for compliance and traceability of actions, institutions spend a great deal of time and resources constructing spreadsheets. They will input the entire slate of variables involved in the real estate process chain in their target investment property. The outcome can be a spreadsheet which is vast, running past a thousand rows down and over a hundred columns with tens of worksheets. It does not end here. Embedded within the spreadsheet could be macros and simulation tables.

Nevertheless, in general, most institutions look first at the initial yield and then run their numbers on whether rents and capital values would rise in time to achieve their internal rate of return. This is the total return that encompasses both the rental received over the holding period and the expected profit upon selling the asset. It is taken as the return on project equity either on a nominal or real basis. By real, it means the nominal internal rate of return less the long term inflation rate of Singapore.

In most models, the growth rate of each variable over the forecast horizon is often taken off the long term rate of increase of only a handful of statistics, namely inflation (for the cost elements), the commercial rental and price increases and the long term interest rate level. For the long term growth rates, some may adopt the 10-year compounded rate of return. This measure is showing good rates with prices and rents for Grade A CBD offices growing at 9.4% and 7.7% pa respectively. (See graph 1.)

Using various time frames from the year 2000 onwards, the annual increases of price and rents have also been encouraging.

Graph 3 shows that the vacancy rates for Grade A CBD offices here are relatively low. Unlike many cities in Asia, where the state of upkeep of an office building deteriorates over time, this seldom or almost never allowed to happen in Singapore with even older buildings sporting low vacancy levels. This means that the effective yield here, after factoring in vacancies is closer to the quoted yield for office space.

Of late, institutions have been shying away from the market citing low initial yields and asset values being afflicted by impending interest rate increases.

To begin with the office market has performed well over the past five years due to low interest rates. The point to make here is that even if interest rates rise, it may not mean that prices and rents will come off.

Graph 4 shows quite clearly that the impact of interest rates on office prices and rents have varied. Generally, from 1990, to 2007, the relation between interest rates and office prices and rents has been positive. It was only when US interest rates fell off a precipice as a policy response to the Global Financial Crisis that rents and prices rose. What this means is that one cannot simply use the argument of future interest rate increases as a reason to shy away from making investments in the commercial space market. If interest rates increase as a result of global economic growth, then it can be a good thing because demand for office space here should increase, potentially offsetting either fully or partially the rate hike.

Secondly, if the interest rate environment reverts to normality, Singapore's interest rates could also revert to the long term "discount" to US rates. From 1990 to 2013, the 3-month interbank rate has been 1.29 percentage points below the 3-month USD SIBOR. The 10-year average is about 0.63%. This phenomenon could possibly arise out of a lack of an interest rate policy here in conjunction with the net cumulative inflow of funds because of the openness and safe haven status of the country.

That our interest rates are generally lower than the US cannot be under-stressed because whilst we may have warded off imported inflation, lower rates would theoretically engender asset price and rental inflation assuming supply remaining constant. This could explain why initial yields here are low. Many foreign institutions hail from countries where their central banks adopt an interest rate policy and they then tend to view our market as though it is similar to their own market dynamics. Consequently, many believe that initial yields should be 5 % to 6% for an investment deal close. Unfortunately, they are generally not likely to see such initial yields because if domestic borrowing costs are low, then yields should be low too. In Singapore, the Grade A CBD office net yield has averaged about 4.9% over the past 10 years. The period when initial yields are above 5% was in the last decade when global interest rates were higher. Today, with rates low, we correspondingly would have low yields too. However, the internal rate of return on equity could still be high because ultimately, both asset and rental price inflation would make up for that.

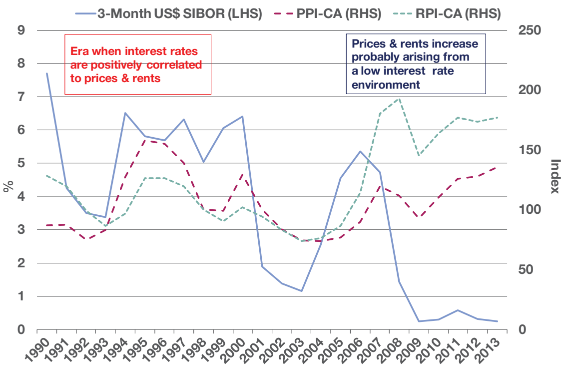
The argument then turns to rising interest rates as a negative sell on investment properties. However, if global interest rates were to rise, it would likely be due to a resumption of economic growth rather than from stagflation. Is the latter a likely scenario? No. Global economic growth is still expected to remain below potential for the foreseeable future as the impact of the Global Financial crisis is still being felt and banks are still in the process of repairing their balance sheets and shedding unnecessary fat. The velocity of money continues to remain low.

It is understandable why foreign institutions have of late been shying away from investing in commercial real estate here. Graph 6 shows the declining net yields of Grade A Office space in the CBD.

Most are fixated on the low initial yields and fears that any rise in interest rates will put an end to rising prices. Some are concerned with the bulge of supply of new office buildings from 2016-2018. We believe that many have over weighted these fear factors and paid less attention to the underlying reasons driving our commercial real estate market. The openness of the economy, ease of setting up businesses, adherence to the rule of law and a high level of personal safety is a magnet for new-to-market and existing companies to set up or expand operations here. The driver for commercial space demand is therefore not only domestic economic growth, but on an equally important note, regional economic prospects. The end result of this is that even if there are times when a larger quantum of supply is released into the market, this would be taken up relatively quickly.

GRAPH 4

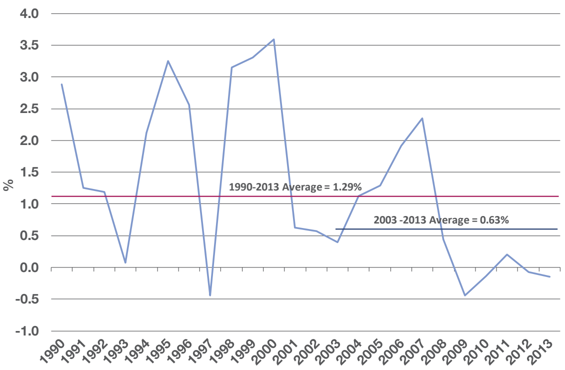
Interest rates and office market performance, 1990–2013



Source: MAS, URA, Savills Research & Consultancy

GRAPH 5

US 3-month SIBOR less 3-month SGD interbank rate, 1990–2013



Source: MAS, Savills Research & Consultancy

GRAPH 6

Net yields of Grade A CBD office space, Q1/2004–Q2/2014

Source: Savills Research & Consultancy

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