Korea - April 2020

SPOTLIGHT

Savills Research

COVID-19 and Korean Property Markets

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The Coronavirus Pandemic and its Impact on Korea's Commercial Real Estate

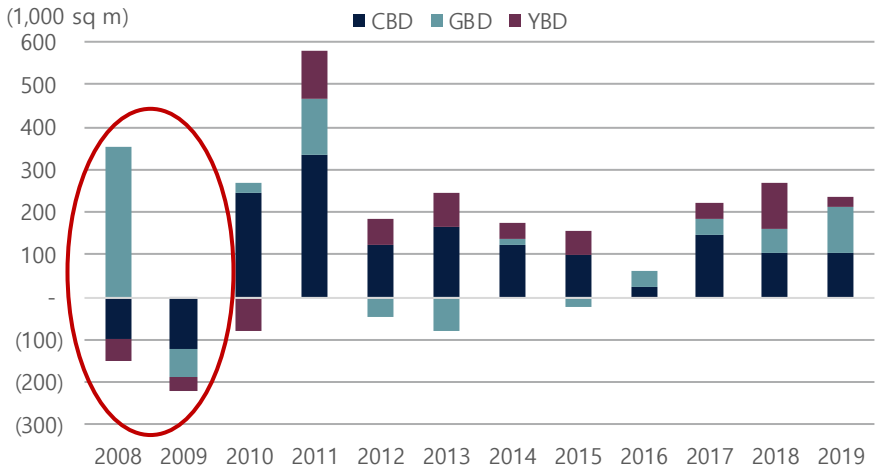
Changes in the macro-environment typically take longer to materialize in real estate markets, relative to foreign exchange or stock markets. But the coronavirus will eventually have an impact on real estate as it has on all industries from finance and manufacturing to exports. As an export-oriented economy, even when Korea overcomes the outbreak, the negative impact will continue to be felt until the rest of the world recovers.

This report will discuss the effects of the recent crisis on the office sector, which represents 70% of the investment market, the rapidly-expanding logistics sector, and data centers, which offer huge growth potential, but will not be covering retail and hospitality, both of which are influenced by high-level policy measures such as border closings and social distancing.

ECONOMIC OUTLOOK

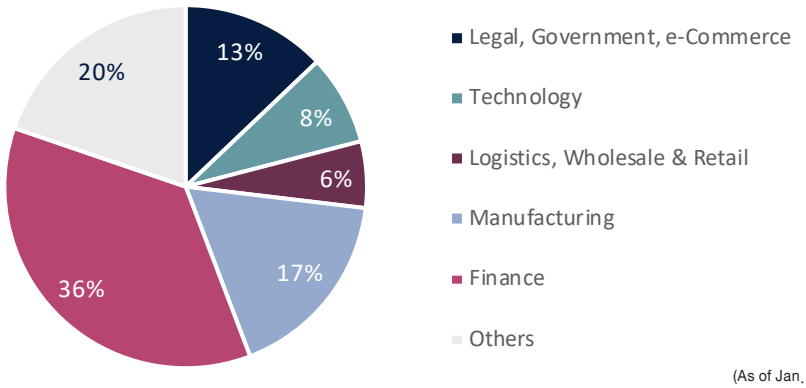
Economic growth in 2019 came in a respectable 2.0% despite the impact of the US-China trade dispute, trade conflicts with Japan, the implementation of a 52-hour workweek, and a minimum wage hike. Preliminary forecasts for 2020 were in a similar range, but the figures have been revised down several times since the outbreak. In addition to the hard-hit tourism, airline and retail industries, declining oil prices and trade volumes have rippled across to the oil refining, petrochemicals, automobiles and steel industries as well. As a result, as of March 22, FocusEconomics[1] forecast rate of growth for 2020 stood at 1%.

GRAPH 1: Net Absorption, 2008 - 2019



Source Savills Korea

GRAPH 2: Prime Office Tenant Industry Breakdown



(As of Jan. 2019)

Source Savills Korea

OFFICES

Since the average prime office[2] lease term is five years, external shocks do not immediately affect lease breaks or reductions in area until contract expiry. As an example, a tightening of demand was not evident in 2008, but followed in 2009.

Office leasing demand will decline in 2020, led by the airline, transportation, tourism and manufacturing industries - which together account for 25% of total prime office space. Companies in financial distress are taking drastic measures, including honorary retirement, unpaid leave, and wage cuts. Given the legal difficulties associated with firing employees, immediate changes in areas leased are not expected.

On the other hand, demand from industries such as legal services, e-commerce, fintech, software, biotech, and government, comprising 20% of prime office space by occupancy, is anticipated to remain healthy or even rise. New demand growth in the prime office market, which has exhibited an average annual increase of 177,000 sq m over the past five years (2014-2019), is certainly expected to slow. If the recent situation is prolonged, direct and indirect rent cuts already happening in the retail sector will spread to the office market, translating into falling effective rents for the worst-performing buildings.

Starting in 2021, companies expect to be downsizing. If companies require less space for their headquarter buildings, vacancy will inevitably rise. Stabilization periods may lengthen on subdued demand levels.

On the supply side, the completion of upcoming projects – equivalent to 8% of total stock as of March 2020 – including the large mixed-use Parc1 and SG Tower, will drive up vacancy starting in Q2/2020 to the end of the year.

In the long-term, despite a rebound in employment, total office area may not increase in absolute proportion to the number of new hires. Companies have had to ask employees to work from home and have received positive feedback from implementing various policies such as rotation duties and hot desks, meaning that there may be a permanent decline in the number of in-office employees.

However, it may be hasty to deduce that there will be a parallel reduction in area. Depending on the industry, companies are likely to introduce more amenities, such as meeting rooms, resting areas, collaboration spaces - ideal for millennials and Generation Z who value individuality - and cafeterias. Plus, as highlighted by the cluster of infections from call centers, the "optimal" office area per worker to ensure a minimum degree of comfort and privacy may be re-defined.

LOGISTICS

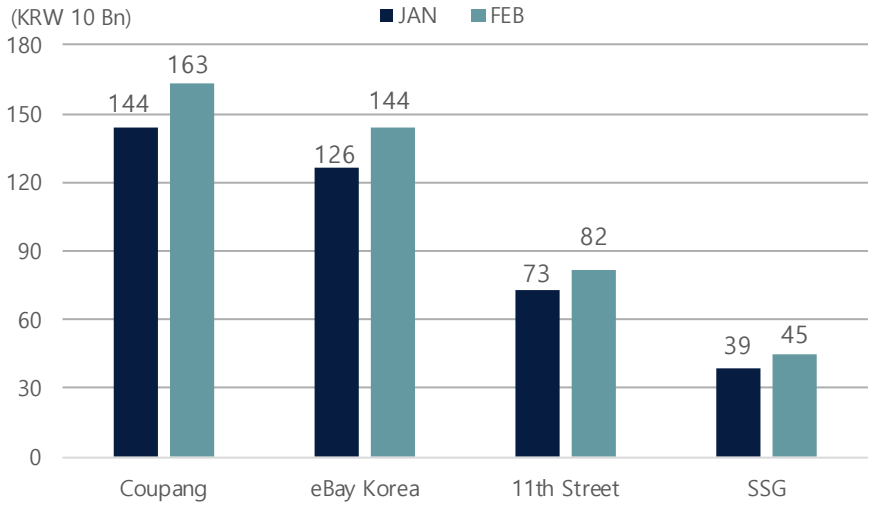
The e-commerce industry, which has expanded exponentially for the past few years, is now surging with double-digit sales growth per month due to "untact" and "work from home". According to a recent survey of Korea's top online shopping platforms, Coupang's online sales jumped from KRW 1.44 Trn in January to KRW 1.63 Trn in February, up 13% in just one month. Other online retailers such as eBay, 11th Street, and SSG are estimated to have seen similar growth.

However, not all nationwide logistics centers are experiencing an uplift in demand, as a breakdown of sales indicates that only small shipments of selective products, mainly daily necessities, have picked up. The outperformers are cold storage and B2C facilities in the Seoul Metropolitan Area ("SMA") capable of last-mile delivery, versus B2B facilities handling import-export goods.[3]

Just as consumers are choosing to avoid e-commerce companies which are unable to keep up with the heightened demand because of a shortage of drivers or trucks, the ability to process goods quickly and efficiently will become a key factor in screening for logistics centers. In addition to securing a labor force, regions must be able to deal with demand, and the introduction of automated systems may become a top priority.

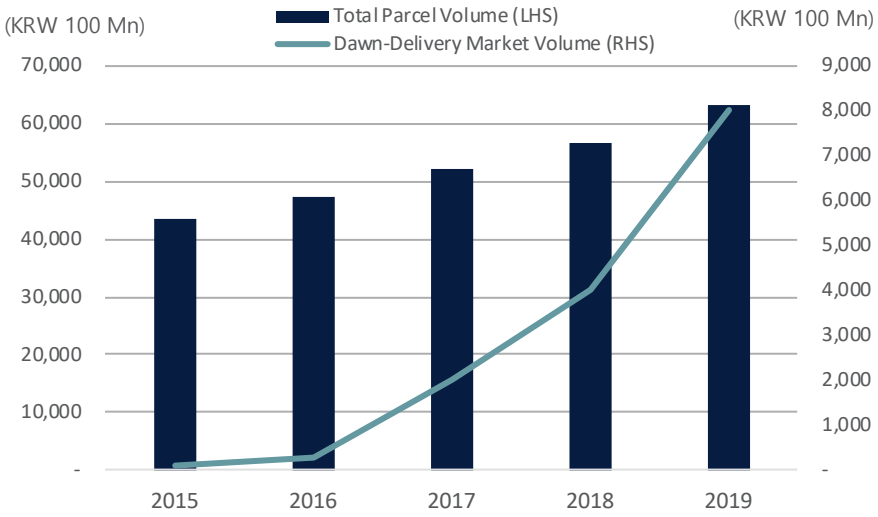
Total stock of logistics centers located in the SMA, each greater than GFA 16,500 sq m (5,000 py), will increase annually by 10% to 2022. Much of the additional supply will be cold storage, further driving the rental and price gap between each of the properties depending on their competitiveness.

GRAPH 3: Total Payment Amount for Top Online Shopping Platforms, 2020/01 - 2020/02



Source Wiseapp, Wiseretail

GRAPH 4: Total Parcel Volume and Dawn-Delivery Market Volume, 2015 - 2019



Source Korea Integrated Logistics Association, Samsung Securities

DATA CENTERS

Korea is globally recognized for its advanced ICT infrastructure, and wireless network traffic volumes are fast-growing. 5G technology, which accounts for 3x the traffic volume of 4G, is forecast to expand by 62%[4] annually on average during the next five years to 2025.

The market is currently dominated by end-users, who own and operate the data centers, including the top three domestic telecommunications services providers and cloud services providers such as Naver and Amazon. Equinix, a global market leader operating more than 200 centers worldwide, was the first in the industry to launch leasing services in Korea in 2019. However, based on the market potential, well-established IT infrastructure, and high-quality electricity supply, hyperscale data centers are appearing in the development pipeline and professional operators are gradually expanding.

The recent crisis has made working from home a reality, but it would not be possible without advanced technologies and cloud services and sheds new light on the significance of IT infrastructure. More corporations are expected to increase investment in this sector to drive full-blown growth.

INVESTMENT MARKETS

For the past two years, the investment market has enjoyed a strong inflow of funds thanks to low interest rates, volatility in equity markets, and favorable government controls aimed at stimulating public offerings. Securities firms also contributed to the rise in prices and the largest transaction volume on record by joining the competition in the form of underwriting total acquisitions.

On March 16, the Bank of Korea slashed the base rate by 50 bps from 1.25% to 0.75%, an historical-low. Generally, lower interest rates would be followed by lower funding rates and lead to price competition, but prices are expected to remain sticky or even decline in the short-to-midterm for the following three reasons.

First of all, the uncertainty in leasing markets outweighs the dip in interest rates. Investment choices regarding each of the assets are determined comprehensively by tenants' financial standing, and creditworthiness, and the sales price is not influenced easily by monetary easing conditions.

Second, financial institutions are cautious when monitoring market conditions and selectively reviewing new loans. Despite the dip in the benchmark rate, the cost of borrowing has not fallen, and new loan approvals are being suspended. Lenders are tending to cut back the share of alternative investments which have increased over the past few boom years.

Lastly, heightened liquidity risk has resulted in a withdrawal or decrease in total underwriting of securities firms. This applies most to companies with high unsold volumes left

on their books. If underwriting activity is significantly reduced in the future, it is expected that sellers may retreat from transactions.

The market has been overheated by rising competition from domestic investors, and foreign investors' share of the office investment market fell from 35% in 2014 to 8% in 2019 as result. While the recent crisis may pose an opportunity to foreign inbound capital on favorable exchange rates, all investors are expected to remain risk-averse for some period. There will be few deals introduced during the first half of the year, as many will likely be delayed to the latter half and this will result in depressed total transaction volumes to below prior-year averages.

During the 2008 Global Financial Crisis, prices dropped 30% in December but had rebounded in only three quarters, outpacing many other markets. Investors familiar with the Korean office market will leverage the downturn to identify attractive investment opportunities amid less competition, and newly constructed, stabilized assets with superior tenants may be sold at higher-than-expected prices.

The logistics investment market is anticipated to see a reshuffling of investor portfolios subsequent to the M&A deals of eBay and Logen Logistics. Logistics companies will also be revising their positioning strategies. After the sector restructuring, there may be more assets for sale, and prices could hold due to higher investor interest.

For transactions in the foreseeable future, we expect the average duration to lengthen and the total number to decrease. On heightened investor preference for safe assets, core office and logistics assets are likely to become more attractive.

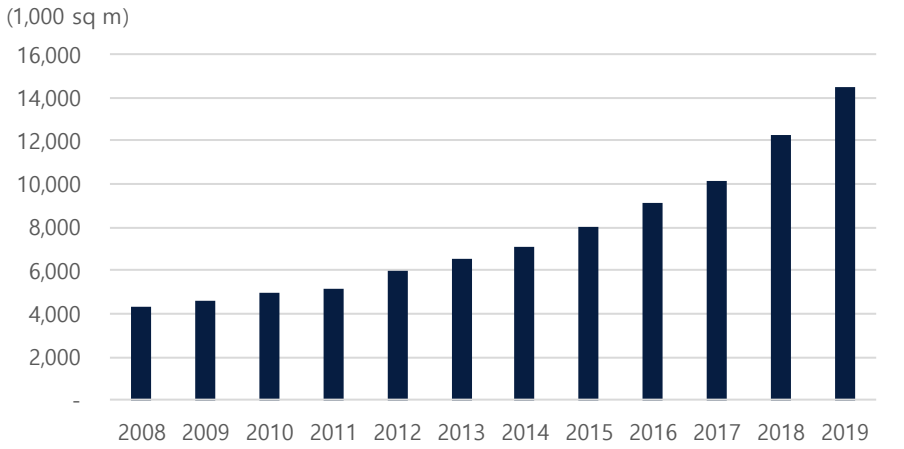
1 FocusEconomics: Report on economic forecasts published by more than 20 foreign financial institutions

2 Savills Korea classifies office buildings based on GFA, location, accessibility, completion year, building facilities, maintenance, and other factors, and prime offices comprise approximately 120 buildings in the major business districts of Seoul

3 According to "Total Container Transport" from January to February of 2020 as published by The Ministry of Maritime Affairs and Fisheries, the amount of imports and exports in the nation's trade ports fell by 4.3% YoY, while China's imports and exports fell by 5.3%

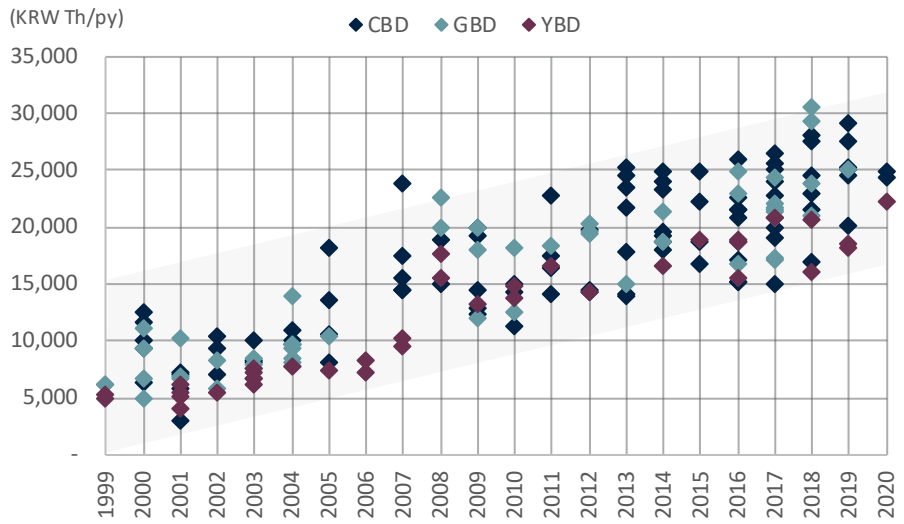
4 Forecasts from KT Research Institute and Korea Internet & Security Agency

GRAPH 5: Total Stock of Logistics over 16,500 sq m in Seoul Metropolitan Area, 2008 - 2019



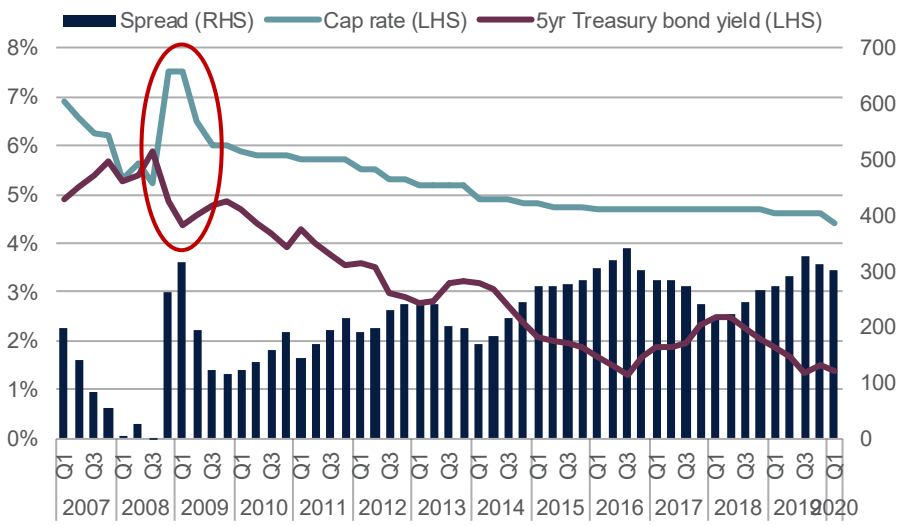
Source Savills Korea

GRAPH 6: Office Per Py Sales Price, 1999 - 2020



Source Savills Korea

GRAPH 7: Cap Rate, Q1/2007 - Q1/2020



Source Savills Korea, Bank of Korea

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