Asia Pacific - July 2023

SPOTLIGHT
Savills Research

Asia Pacific Office Markets

Office demand in Asia Pacific - down but not out

INTRODUCTION

Office investments have long been a highly favored asset class offering dependable risk adjusted returns. In the new post pandemic environment however, the sector faces a fresh range of challenges which have caused investors to question old orthodoxies.

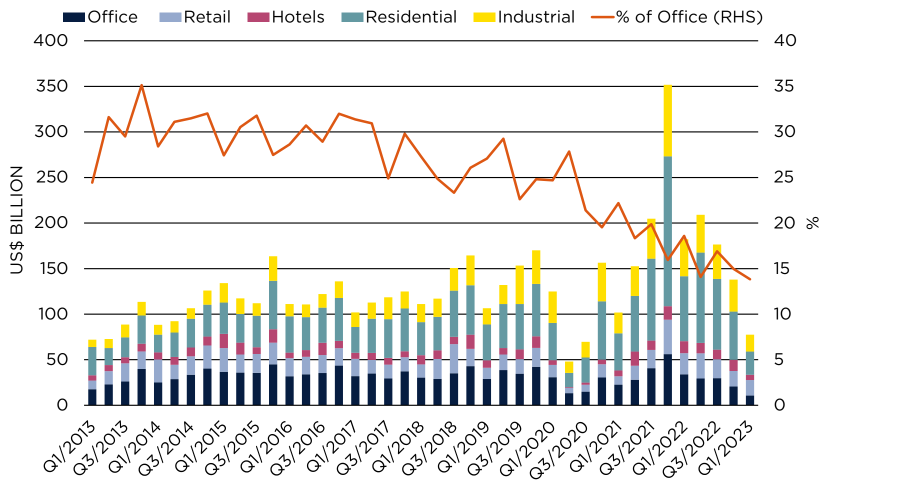
THE US HAS BEEN PARTICULARLY HARD HIT

In the US the pandemic was followed by the so-called 'great resignation' while work from home practices became entrenched particularly in cities with longer commutes and a tech heavy business environment. Some workers took the opportunity to move further from their places of work to more tax friendly states while in some cities, most notably San Francisco, mismanagement meant that downtowns descended into theft, drug addiction and homelessness. This toxic brew has resulted in a New York vacancy rate of close to 23% while US commercial real estate now faces US$64 billion of troubled assets.

DISRUPTION IS WIDESPREAD

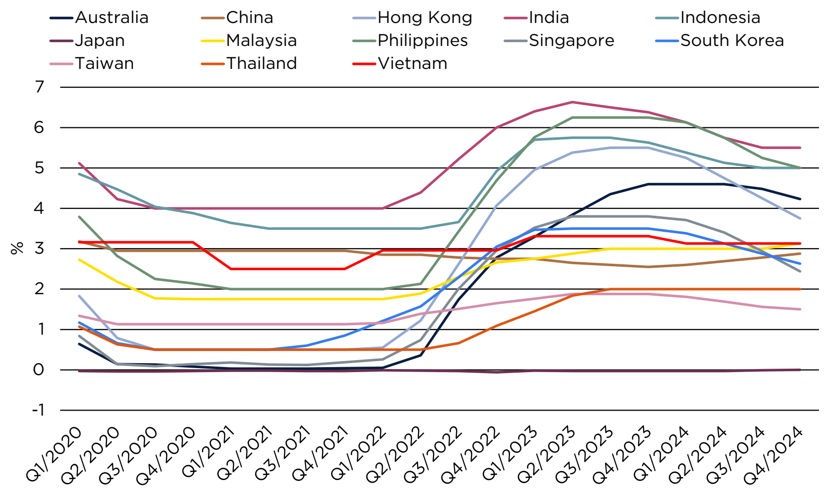
So what has gone so horribly wrong? Challenges appear to fall into four baskets. Cyclical issues include inflation, elevated interest rates and slower economic growth while market specific factors also have a role to play with many markets facing elevated supply, lackluster demand and higher vacancy levels. There are also structural factors at play including the impact of new technologies, demographics, urbanisation, and a shift from manufacturing to services. Lastly, more extensive ESG regulations mean that the cost of environmental compliance has been rising year-on-year.

GRAPH 1: United States Transaction Volumes by Asset Class, Q1/2018 to Q1/2023



Source MSCI Real Capital Analytics, as of 18 Apr 2023
Note Office, retail, industrial, apartment, and hotel transactions included. Entity level deals included. Development sites excluded. Based on independent reports of properties and portfolios US$2.5 million and greater. Data believed to be accurate but not guaranteed.

GRAPH 2: Interest Rates by Market, Q1/2020 to Q4/2024F



Source FocusEconomics, Oxford Economics

INFLATION, INTEREST RATES AND GROWTH

Post pandemic global supply chain disruption caused an inflationary shock which central bankers moved to mitigate by increasing interest rates which has inevitably slowed growth. For real estate investors higher borrowing costs and reduced occupier demand are having undesirable consequences across all geographies.

Asia Pacific has not been immune to inflationary pressures principally in the form of higher food and fuel costs, but on the whole price rises have been more subdued than in the US or the Euro area. Interest rates nevertheless have had to rise, and this is squeezing consumers, companies and governments who all took on more debt during the pandemic. Fortunately for the region, banking strains have so far been avoided.

In terms of growth, China is casting a long shadow over the region and overseas export markets remain weak. The good news is that domestic demand in the region has stood up well and tourism numbers are returning to pre pandemic levels. The IMF estimates that Asia Pacific will contribute 70% to global growth this year, a rare piece of good news.

DEMAND WEAKENS, SUPPLY SPIKES, VACANCIES RISE AND RENTS FALL

Turning to look at the fundamentals of the regional office markets, rents across the board have seen declines from 2019 onwards (with the notable exception of Seoul). Particularly heavy falls have been noted in Shenzhen, Guangzhou and Hong Kong, possibly as a result of prolonged pandemic restrictions, but the markets have also been dogged by oversupply and weak demand particularly from technology companies after the regulatory crackdown in China. Hong Kong has also lost tenants to Singapore thanks to a period of political and social turmoil.

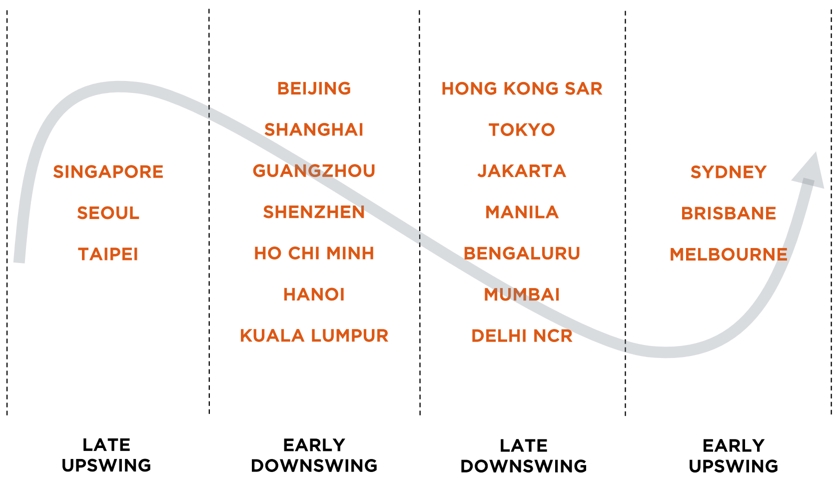
Elevated vacancy rates of 15% plus have been most marked in the mainland cities of Beijing, Shanghai, Guangzhou, and Shenzhen driven by higher levels of new supply rather than any changes in working practices. With a few rare examples most of the region's cities are currently in an early or late downswing in terms of rental market cycles. Given that the environment is likely to remain challenging, few markets are expected to see a rapid turnaround soon and vacancy should maintain at current levels or rise marginally out to 2024.

While not immune from slower growth and changing work place practices, we have reason to believe that office demand in Asia Pacific is better underpinned than it is in either Europe or North America.

INVESTORS REMAIN WARY

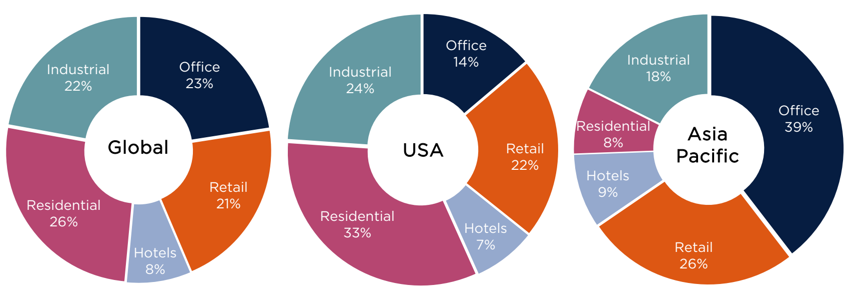
In the investment markets yields have remained stubbornly low across most asset classes with the exception of hotels where yields have moved out quite substantially and the last year or two has seen plenty of opportunities with active investment markets most notably in Japan and Korea. In the retail market the recovery story has also found appeal among investors while office pricing has remained high. The result has been a contraction in transactions volumes this year and volumes are expected to remain depressed into 2024 unless or until yields push out in response to the higher cost of capital. The good news is that while volumes are lower, offices in the first quarter of 2023 have remained a popular asset class representing 34% of all deals in Asia Pacific, a sharp contrast to the US where office deals accounted for only 7% of the total with industrial assets representing a whopping 69%.

GRAGH 3: Grade A Office Market Cycles, Q2/2023



Source Savills Research & Consultancy
Note Late upswing: rental values rising, but growth is slowing
Early downswing: rental values falling
Late downswing: rental falls accelerating, close to reaching bottom
Early upswing: rental values rising

GRAGH 4: Investment Volume by Asses Class, Q1/2023

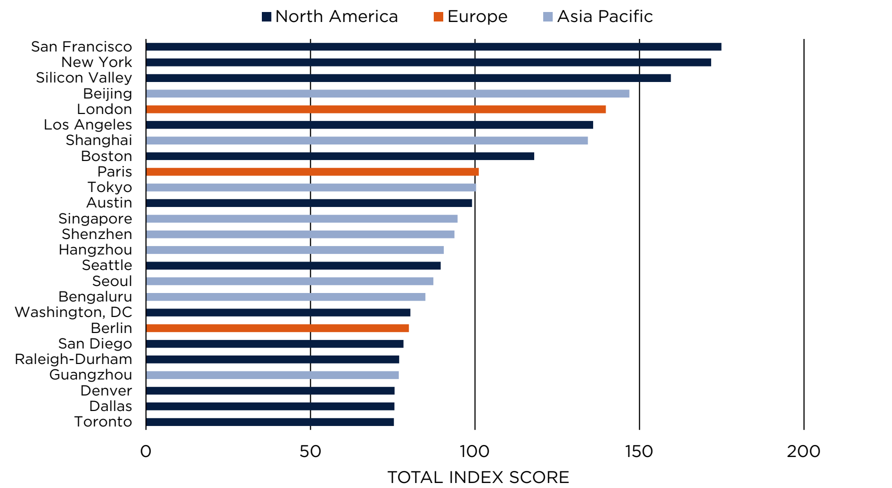


Source MSCI Real Capital Analytics

STRUCTURAL CHANGES WILL BE SIGNIFICANT BUT HARD TO QUANTIFY

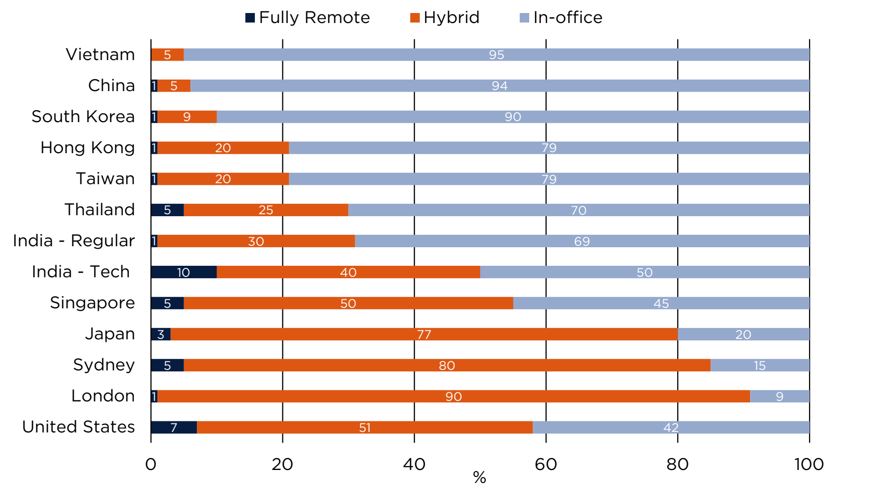
If cyclical and market specific factors are weighing on the office markets so too are structural issues. Technological advances are being made on many fronts from web 3.0 to blockchain, augmented reality, virtual reality, smart contracts, proptech and e-commerce. More recently artificial intelligence has quickly moved to the top of the agenda for many businesses.
It is notoriously difficult to predict the consequences of such widespread advances, but it is hoped that they will lead to a cleaner, greener future offering greater market transparency and improved liquidity while easier transfers of title could be hugely beneficial. Historically, more jobs are created than destroyed by the introduction of new technologies while it is also expected that the nature of work itself will be transformed. Complex technologies though take a time to implement - most of us are still unsure of how to use AI effectively for example.

GRAPH 5: Top 25 Savills Tech Cities, 2023



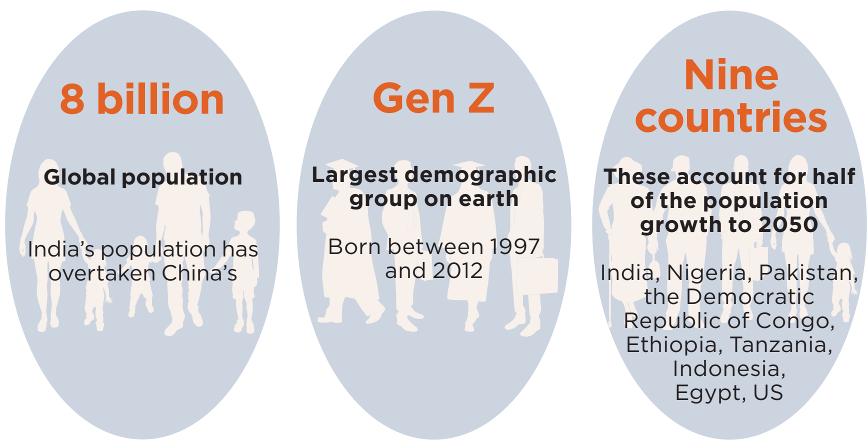
Source Savills Research & Consultancy

GRAPH 6: Share by Working Model across Major Grade A Office Tenants, Q2/2023



Source Scoop Flex Index, Savills Research & Consultancy

GRAPH 7: Gen Z is Shaping the Future



Source Savills Research & Consultancy

TECHNOLOGY AND THE KNOWLEDGE ECONOMY

Demand from technology companies over recent years has displaced finance in many international markets. The knowledge economy of the future will most likely be dominated by tech cities with a range of attributes including a conducive business and tech environment, a city buzz and wellness bias and a strong talent pool. The world's best universities have also become important sources for the most highly skilled workers of the future as they tackle the biggest environmental, scientific, engineering and humanitarian issues the world faces. Business needs to both link to these institutions and use them to recruit skilled graduates. The most in demand individuals will also gravitate to high performing businesses and technology clusters pushing up rents and capital values in those locations.

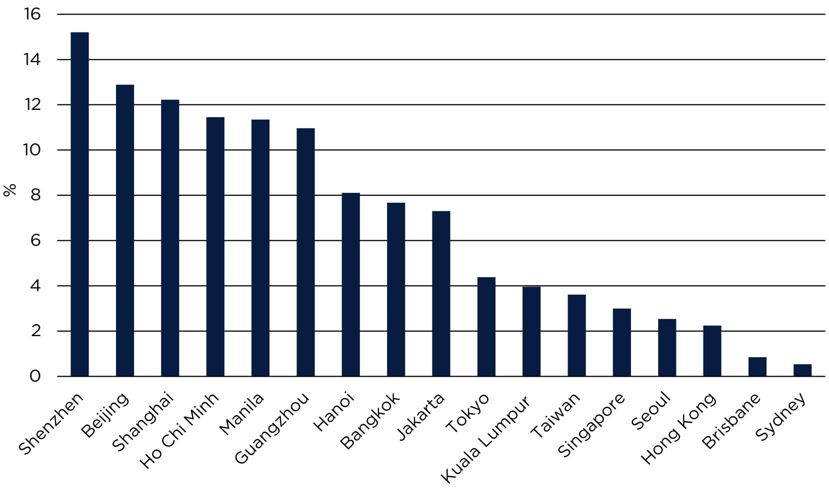
THE RISE OF HYBRID WORKING

Hybrid or flexible working has attracted a great deal of media attention as remote working became a feature of life under COVID. In 2022 surveys suggested that most people preferred flexible working to either being in the office full time or being based entirely at home. The reality in Asia Pacific, much more so than in the US or Europe, is that in 2023 most people are returning full time to the office with some residual hybrid activity. Generalizations are difficult though, and a lot depends on the average length of commute, size of home, whether the prevailing management culture is either conservative or liberal, the quality of IT infrastructure and on an individual basis, whether your work has a need for collaboration and/or client contact or is predominantly 'back office'.

CHANGING DEMOGRAPHICS

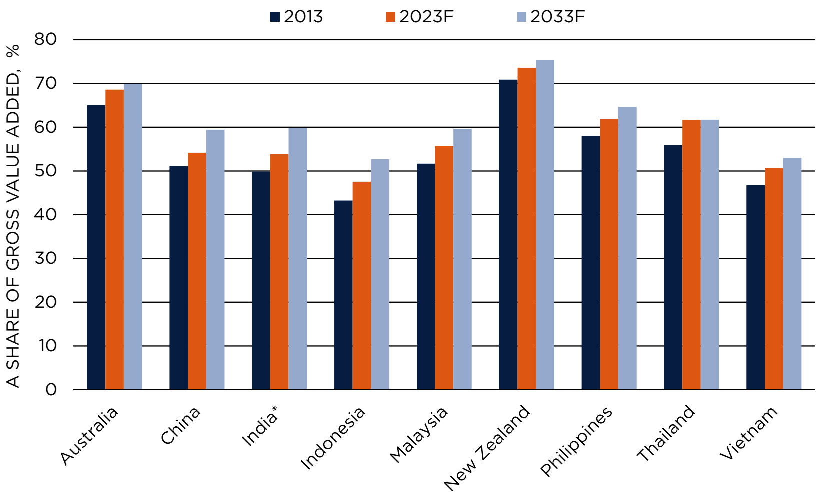
According to the World Economic Forum 'the demographic dividend in developing and emerging economies rates highly as a net job creator'. So what are the notable characteristics of today's demographics? In a world of eight billion people the two most populous nations remain India and China, and India has just overtaken China with a population of 1.4 billion. It is estimated that China's population however could fall below 1 billion by the end of the century while India's is expected to peak at 1.7 billion in 2064. Another notable characteristic of the global population is the rise of Gen. Z who now represent around 25% of the total. Gen. Z has been immersed in the Internet from birth, is focused on well-being and ESG and has a high desire for flexible working and a healthy work/life balance; all characteristics which future landlords and employers would

GRAPH 8: Grade A Office Stock CAGR by Market, 2013 to 2023



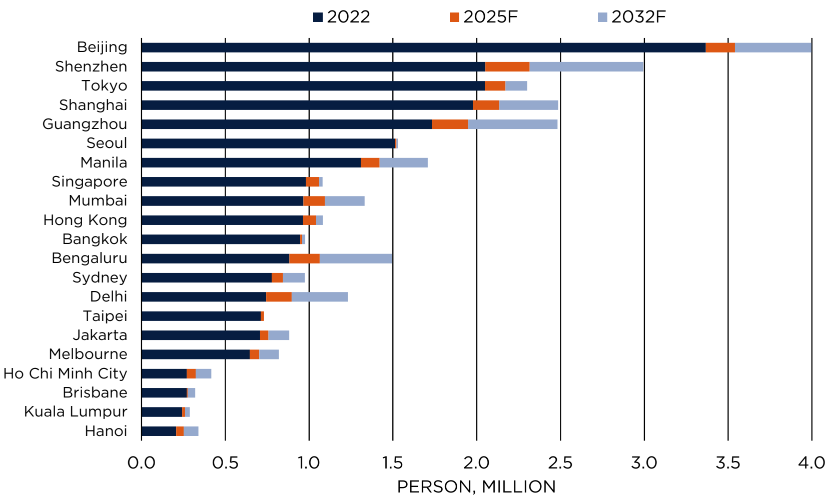
Source Savills Research & Consultancy

GRAPH 9: Service Output Share of Economy by Market, 2013 to 2033F



Source Oxford Economics
Note *India is calculated using gross valued added of services divided by gross domestic product.

GRAPH 10: Office-based Employment by Market, 2022 to 2032F



Source Oxford Economics

do well to pay attention to. In Asia Pacific ASEAN nations and India house the youngest populations. These populations are often referred to as 'high fertility, high mortality' and drive demand for housing, education, and services. They are typically more dynamic and more entrepreneurial (the average age of an entrepreneur is around 30 years) and will help drive demand for office-based employment. Older populations are found in northeast Asia and are often referred to as 'low fertility, low mortality'. Typically, they generate demand for senior housing and healthcare and are characterized as being less innovative and less dynamic.

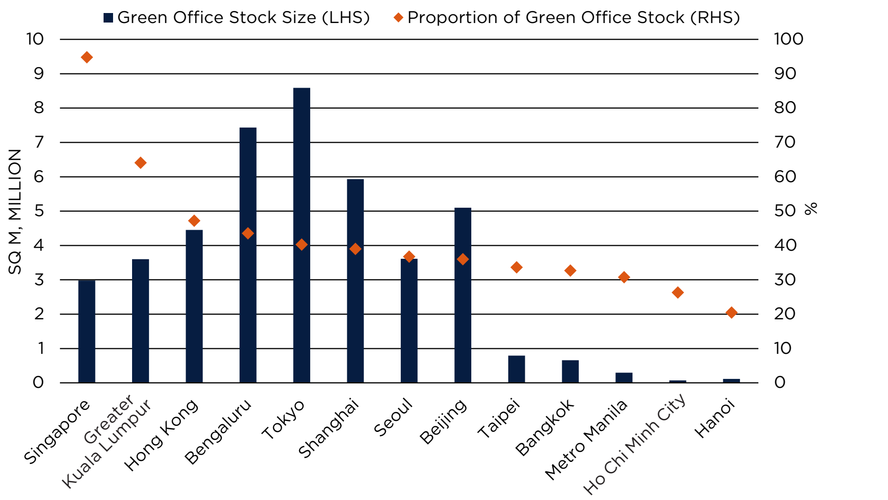
BOOMING SERVICES

Besides their youthful populations Southeast Asian nations and India are also characterised by a structural shift from manufacturing to services and technology and this has helped drive booming demand for offices over the past 10 or so years. Technology which facilitates remote working has also seen the development of 'business process outsourcing' in the Philippines and India. India has also developed so-called 'global capability centres' of which there are around 1,600 currently. Bangalore is known for hosting such offices and multinationals located in the city include Goldman Sachs. Rolls Royce. Wells Fargo and Saks 5th Ave. This shift to services is expected to continue over the next decade further stimulating demand for offices and reflecting this, India's services exports have surged post pandemic.

CITIES AND 'MEGACITIES'

Urbanisation is also expected to stimulate demand for office-based employment. The global urban population overtook the rural population in around 2006. In high income countries urbanization levels are typically above 80% while in upper middle-income nations that figure is somewhere between 50% and 80%. Given our forecasts for the growth of urban populations over the next 10 years, China and India are each expected to see over 100 million people move from the countryside into towns and cities while in Indonesia that figure is around 30 million and in the Philippines 20 million. Cities mean better employment prospects, better access to education and health care and if well managed, a greener and more sustainable environment. If, however, urbanization is mismanaged the result can be poverty, overcrowding, disease and insecurity. Currently 19 of the world's 33 megacities of over 10 million are in Asia. By 2050 Asia will represent 25 out of 47 global megacities with the addition of Nanjing, Chengdu, Ho Chi Minh, Surat, Pune and Ahmedabad.

GRAPH 11: Green Stock Across Grade A Office Markets, Q3/2022



Source Savills Research & Consultancy

THE GREEN REVOLUTION

Asia Pacific generally has been a slow adopter of ESG although some cities have made more headway than others. Currently 95% of Singapore's grade A office stock is green certified while that figure stands at 64% in Kuala Lumpur and 50% in Hong Kong. Tokyo, Shanghai and Beijing also have substantial volumes of green stock. If governments are to meet net zero targets current regulations surrounding sustainable buildings will have to be tightened going forwards and investors will increasingly be faced by the stark fact that uncertified buildings will become unsellable and untenable. Too many regional office markets today are under certified and in most that means less than 40% of grade A stock. This presents opportunities for investors but also obvious dangers in terms of the cap ex which may be required to bring a building up to acceptable environmental standards. Our research shows a clear green rental premium developing which we estimate at around 5% to 10% in today's market. While this premium may diminish over time the risk of ending up with stranded assets will not.

FUTURE OPPORTUNITY

Office markets are clearly having to adapt to the rapidly changing environment in which they find themselves and investors will have to look harder to find value and to mitigate emerging risks but opportunities do exist. Core locations currently seem to be holding up well particularly mixed-use environments which offer the buzz of downtown and strong transport links. High growth markets are also appealing with well-educated and youthful demographics offering both energy and innovation while centres of scientific and educational significance should also flourish as brains will feed the new knowledge economy. Also appealing are markets taking advantage of catch-up growth in terms of urbanization and service sector evolution. Buildings which meet strict green compliance standards will also come into their own as well as buildings with a high level of amenity and tech enabled property assets.

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