Capitalandinvest.com

Private Equity I Real Assets

Finding Opportunity in Volatility within Asia Pacific

Reprioritising Fundamentals in Challenging Times

June 2023

Introduction

As we approach the midpoint of the year, volatility continues to make its mark on markets and investors worldwide. But there have been some glimmers of hope as global headline inflation has started to ease as a result of declining energy and food prices.

The global outlook for the year ahead is expected to be marred by a slowdown in GDP growth, a continued rise in interest rates and a more targeted approach by many governments in fiscal support measures.

As we narrow our focus to the Asia-Pacific (APAC) region, the outlook is brighter. 2023 has so far been an encouraging year, and we expect that the region's investors will benefit from the developments that have unfolded so far, in the months and years to come.

This report looks at the APAC real estate investment landscape and how it has fared and will play out amid the current macroeconomic backdrop. We have considered multiple drivers including post-COVID-19 dynamics, evolving demographics and market fundamentals with the aim of pin-pointing opportunities that underscore the resilience and resourcefulness of this market in challenging times.

We hope our latest *Perspective* offers a compelling view into what we believe is one of the most vibrant and dynamic regions in the world. To discuss our outlook on APAC and the real assets landscape worldwide, please reach out to the CapitaLand Investment team.

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Investors in APAC will continue to benefit from the proven resilience and resourcefulness of the region as the global macroeconomic landscape continues to evolve.

Asia Pacific (APAC) remains strategically positioned to weather the volatile global backdrop but going back to basics will help manage risks and capture emerging opportunities in the region.

Turning Volatility into Opportunity: What's on the Investment Menu in APAC?

The macroeconomic climate is shrouded in uncertainty, but a closer look at APAC against this backdrop reveals myriad opportunities for various risk appetites and investment horizons. Now is a judicious time for investors to review, recalibrate and diversify sector allocations within their global real assets portfolio to counter implicit market risks and the impact of the denominator effect.

So, how can investors benefit from ongoing cyclical and secular trends across APAC?

As long as interest rates are high and return enhancers are low, investors should take a renewed focus on market fundamentals and assess prospective investments through a clear lens of opportunity:

1. **Core / Core+:** Incremental access to prime-grade commercial assets with solid attributes in strategic locations, and asset classes that will thrive given the current demographic trends and which are well-positioned to deliver stable and risk-adjusted returns
2. **Value Add / Tactical:** The evolution of workspace strategies has paved the way for potential lower-grade assets that are ripe for repurposing or upgrade as part of a lease-up strategy; incorporating energy efficiency and sustainability practices presents another layer of opportunity within data centre developments and enhancements
3. **Opportunistic / Contrarian:** Elevated repricing and refinancing risks are creating more viable opportunities for distressed investments, credit strategies, and potentially attractive entry points for core office and retail assets

Figure 1: Summary of Target Investment Strategies in APAC

Core / Core+ / Growth	Value Add / Tactical	Opportunistic / Contrarian
Target **institutional grade offices** in core locations in gateway cities	Identify well located **non-grade A offices** in established CBDs with refurbishment potential	Take advantage of cyclical slowdown for attractive entry to **prime office assets**
Pursue **prime modern logistics and cold storage facilities** in tight markets	Purchase **'brown' non-grade A commercial assets** in strategic locations	Capitalise on pricing dislocations for dominant core **retail assets**
Acquire **multifamily, build-to-rent** and **coliving assets** in major capital cities	Explore **serviced residences and hotels** in core cities to benefit from the return in global tourism	
Evaluate **business and IT parks** in select Emerging Market Tier 1 cities underpinned by the Biomed, TMT & IT / ITeS sectors*	Exploit gaps in the capital stack for **credit** (e.g. stretched senior, mezzanine loans) and **distressed** opportunities; Examine **data centre developments** in advanced markets and select Tier 1 cities in Emerging Economies	Ongoing focus in top Emerging Markets of **China**, **India** and **Vietnam**

Source: CLI Group Research, May 2023
*Biomedical, Technology, Media & Telecommunications, Information Technology & Information Technology-enabled Services.

APAC'S APPEAL IN A CROSS-REGIONAL STRATEGY

The market slowdown has spurred investors to explore growth markets in a bid to supplement and diversify their real estate portfolios which typically have a domestic bias, in terms of economic[1] and property market[2] exposure. APAC is rich with growth markets, with a number of cities well supported by secular tailwinds and robust economic growth potential. We expect the ongoing institutionalisation of APAC markets to deepen the pool of investment products and accelerate their pace of maturity.

Incorporating APAC real estate into a US or European domestic portfolio can meaningfully lower overall volatility and enhance risk-adjusted returns (i.e. gross return per unit of volatility)[3]. For instance, adding a 30% APAC allocation to a US-only portfolio would improve the gross return per unit of volatility from 0.84 to 1.04 and a Europe-only portfolio would see a similar uptick from 0.59 to 0.85.

In addition, APAC currencies, spurred in part by interest rate differentials, have steadily depreciated against the US dollar since 2021[4]. This could be an added sweetener for investors looking to increase their exposure to the region.

1. Fundamentals are Fundamental in Challenging Times

CENTRAL BANKS, LED BY THE FED, ARE STILL IN A TIGHT SPOT

The world is experiencing extraordinary volatility. We are in the midst of the steepest rate hike cycle in recent history[5]; and as data promised a flicker of optimism, the recent fallout from the banking sector added further pressure on yield spreads and shone a light on possible systemic risks reminiscent of the Lehman crisis. The Fed set a discordant tone with rhetoric of a "*mild* recession" that was a sober reminder of the recent "inflation is transitory" era postulated towards the end of 2021.

The next move from global central banks must be highly calibrated, as they trudge towards their inflation targets, while also keeping a watchful eye on the productivity side of the equation.

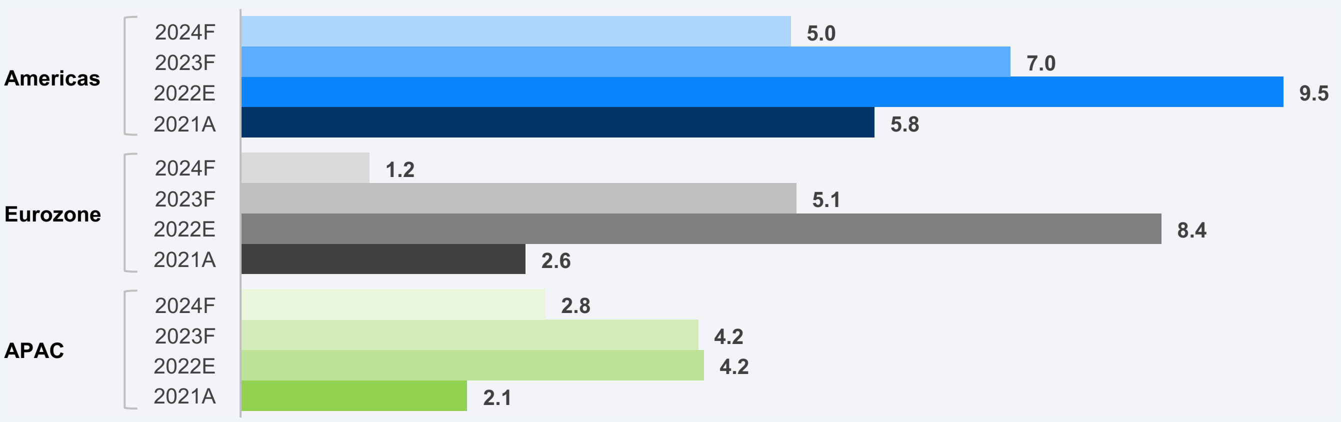
SIGNS OF DISINFLATION PROVIDE SOME COMFORT

Price pressures in developed markets around the world have receded from multi-decade highs on the back of subdued demand and easing supply chain issues. Cost-push inflation is currently the main play, and the patchy and gradual reopening of borders across APAC stalled money velocity and tamed headline inflation in the process.

APAC's steady wake from the pandemic, as seen most recently with China reopening its borders, may well have a more limited real shock in demand than anticipated. It is likely that inflation in developed countries, including Japan and Australia, will reach its apex by mid-year, and this will be followed by a gradual move to more normalised levels towards the end of 2023.

We anticipate structural inflation levels to be higher than the past two decades, which may necessitate an increase in long-term inflation targets by central governments. The knock-on impact could drive comparatively tighter monetary policies and potentially higher benchmark rates in time to come.

Figure 2: Inflation by Region (2021A-2024F)



Source: Oxford Economics, CLI Group Research, May 2023

1 Economic diversification based on pairwise correlations of GDP growth for the period 1990 to 2022 for US-APAC and EU-APAC which were recorded at 0.45 and 0.58, respectively, while the figure for US-EU was 0.77. Source: Oxford Economics, IMF WEO, CLI Group Research.

2 Property market diversification based on pairwise correlations of real estate annual total returns for the period 2007 to 2021 for US NCREIF-MSCI APAC and MSCI Europe-MSCI APAC which were recorded at 0.25 and 0.00, respectively. Source: Bloomberg, MSCI, NCREIF, CLI Group Research.

3 CLI Group Research analysis, based on annual data from the US NCREIF Property Index, MSCI Europe Total Returns and MSCI APAC Total Returns for the period 2007 to 2021.

4 Between January 2021 and April 2023, the aggregate depreciations of the respective APAC currencies against the US dollar were recorded as follows: Japanese Yen (-29%), Korean Won (-23%), Australian Dollar (-16%), Indian Rupees (-12%), Chinese Yuan (-6%) and Singapore Dollar (-1%).

5 Comparing total change in effective federal funds rate over duration across the various rate hike cycles from March 1988 to present.

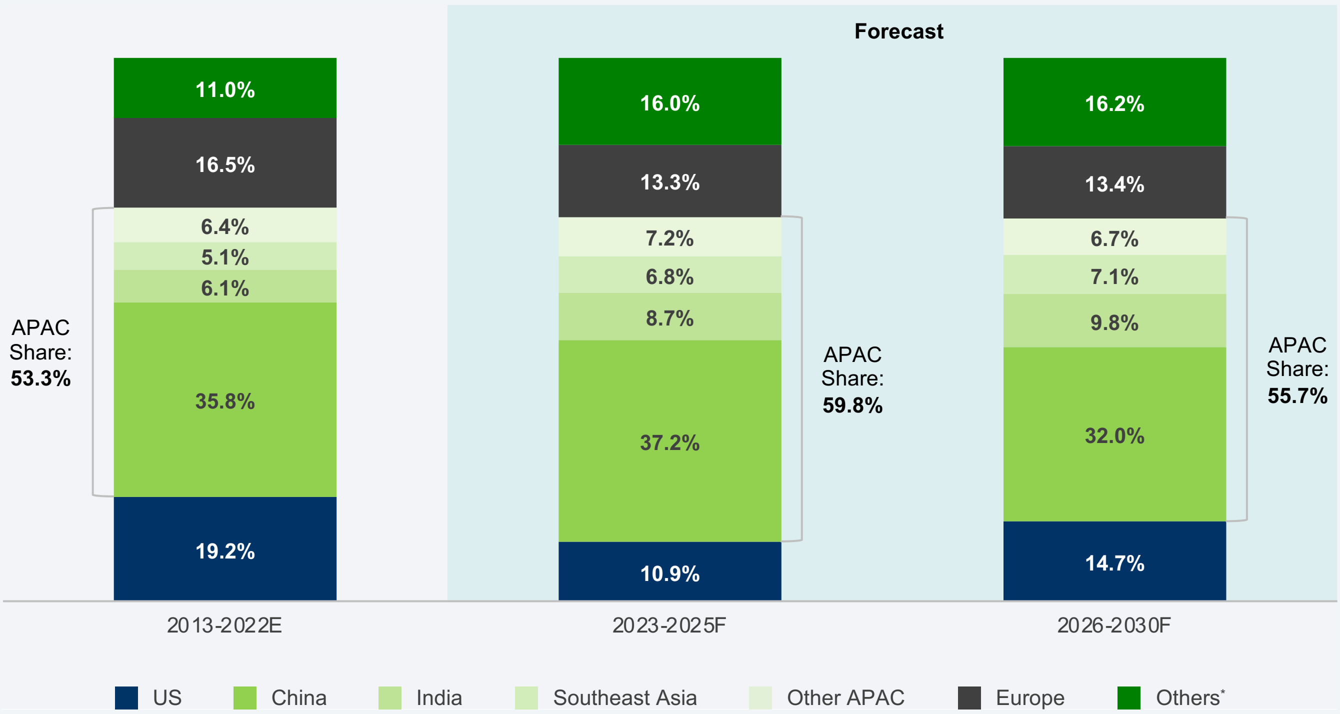
APAC'S PLACE IN THE GLOBAL INVESTMENT ARENA

Although growth targets have been cut considerably around the world over the past year in response to continued elevated inflation and the relentless monetary tightening cycle, some positive signs are emerging: China's reopening, for example, has augmented APAC's near-term growth outlook over recent months, for the first time in three years[6].

In spite of this, APAC's place in the global economy has not wavered and is unlikely to in future. APAC sets the scene for the global growth picture: its economy is forecast to almost double in size by 2030 to contribute close to 40% of global GDP[7]. A closer look shows that China, India and Southeast Asia[8] alone will account for half of the global growth within this period (Figure 3).

APAC has been at the forefront of growth for the last decade, and this is not expected to change, thanks to deep and healthy labour pools, favourable demographics and outsized urbanisation rates. This presents a window of opportunity for long-term investors with dry powder ready to acquire quality defensive assets in APAC that are underpinned by these megatrends[9].

Figure 3: Real GDP Contribution to Global Growth (2023 to 2030F) – by Country and Region



Source: Oxford Economics, CLI Group Research, May 2023
*Includes Middle East, Africa, Americas Ex. US.

GLOBALISATION TO REGIONALISATION

We have yet to see the full extent of APAC's potential as a regional manufacturing and business hub, but ongoing supply chain shifts are already trending towards increased regionalisation.

Growing protectionist political tensions and divergent trade priorities between the US and China and its regional allies have opened the portal to structural shifts in supply chain strategies, as evidenced by the shift of global conglomerates' manufacturing and new technological ecosystems into APAC.

Additionally, the unrelenting grip of data protection regulation, coupled with better digital infrastructure and business compliance, has prompted an increase in regional as well as domestic data onshoring. This trend of tightening regulations continues to swim against the tide of technological advancements and innovations which are otherwise prevalent within major gateway cities.

The extensive and incremental focus on APAC has made its mark on inward foreign direct investment flows, with the region forecast to register the highest compounded annual growth rate (CAGR) among its global peers over the next decade (Figure 4).

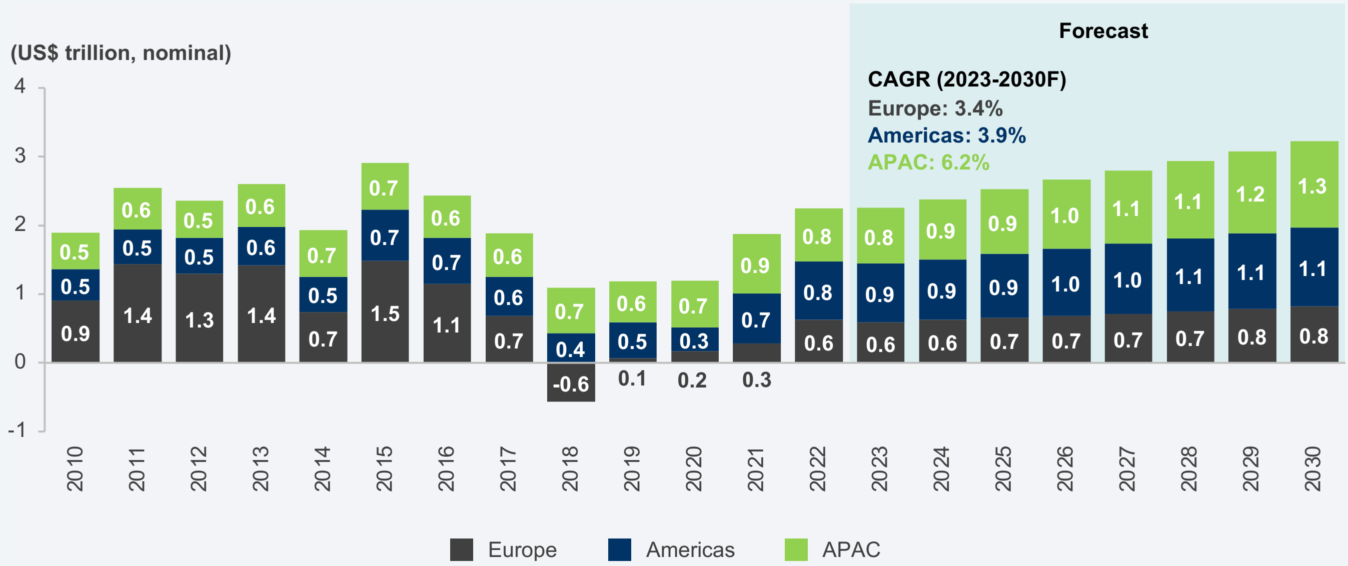
6 IMF World Economic Outlook, January 2023; World Bank East Asia and the Pacific Economic Update, April 2023.

7 In nominal US$ terms. Source: Oxford Economics, March 2023.

8 China is projected to remain as the second largest economy (in nominal US$ terms, constant prices and exchange rate basis) behind the US, while India is expected to become the third largest economy by 2030. Collectively, Southeast Asia would overtake Germany to rank behind Japan (fourth largest economy in 2030). Source: Oxford Economics, March 2023.

9 Seven key megatrends: Recalibrating Retail, Evolution of the Workspace, Return of International Travel, Structural Demographic Trends, Sustained Urban Migration, Supply Chain & Data Fragmentation, Rise of Sustainability. Refer to CLI's 2022 Annual Report.

Figure 4: Inward Foreign Direct Investment by Region (2010A to 2030F)



Source: Oxford Economics, CLI Group Research, May 2023

2. Real Estate in APAC Better Positioned Strategically than its Global Counterparts

A TALE OF TWO REGIONS: APAC AND THE US

The banking turmoil and cyclical weakness in the US office markets have led to a wave of defaults among landlords which have hindered asset values. Lending conditions are unlikely to improve in the near term, which, along with a persistently underperforming office sector, could lead to a 'negative feedback loop'. This could further undermine the integrity of the financial and commercial real estate ecosystem.

The chance of a similar scenario in APAC appears remote, due to the resilience of the local office markets. Corporates and employees alike are readily embracing the return-to-office, with hybrid workspace strategies taking hold, as evidenced by the high office occupancy rate in APAC gateway cities[10] which vastly outshines that of the major US metro cities[11].

Add to this the dynamics of the office occupier demand pool, which are underpinned by robust fundamentals driven by secular trends such as infrastructure modernisation, institutionalisation of financial markets, combined with a shift towards higher value-added manufacturing and a growing consumer class.

Despite the relative resilience of APAC's commercial real estate sector, there are incremental alternative investment options in the debt and mezzanine space. These have been driven in part by the steep interest rate hikes in select developed economies, which appeal to investors seeking lower-risk options across the capital stack with more downside protection against an increasingly volatile market backdrop.

In the absence of well-established options for core debt instruments such as CMBS and REITs in the region, investors can turn to developed markets such as Korea and Australia (where banks are reticent to lend) and emerging markets such as China and India, to access diverse investment opportunities.

OPERATIONAL CAPABILITY IS KEY TO COUNTERACT LOWER CAPITAL GROWTH

Higher interest rates and cyclical low yield spreads have mounted repricing pressures on real estate assets and portfolios amid yield decompression. This has been further exacerbated by a more moderate rental growth outlook, considering the ongoing slowdown across most major economies. We expect the continued flight-to-quality in response to the secular change in occupier workspace strategies could lead to further bifurcation of performance between Grade A and non-Grade A assets.

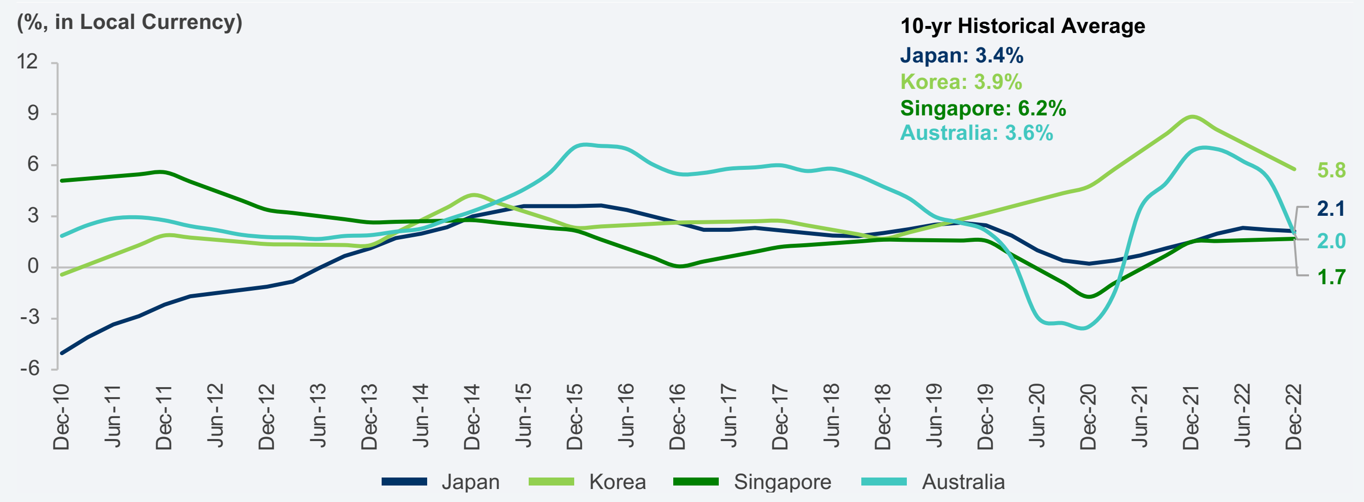
In some developed markets such as Korea and Australia, the ripple effect of elevated interest rate levels is clear, as costs escalate and market liquidity plummets. We expect that steadfastly negative real consumption growth and unwinding debt levels will suppress consumer and corporate sentiment, which could curtail any meaningful expansionary demand for commercial real estate over the next couple of years.

Financial leverage is no longer the name of the game. Operational capability, which expands across on-the-ground presence and more active asset management approaches, is critical to truly sustain net operating income (NOI) growth to compensate for diminishing capital returns (Figure 5), and potentially deliver alpha returns over the medium term. Deploying capital with vertically-integrated investment managers with extensive experience and operational capabilities in these areas will be key.

10 The average occupancy rates as a percentage of pre-pandemic levels stood at 40% to 60% in the US, 70% to 90% in EMEA and 80% to 110% in APAC. Source: Jones Lang LaSalle, March 2023.

11 Average office attendance in 10 major US metros was recorded at 49% as at 29 March 2023. Source: Kastle Systems.

Figure 5: Annualised All-Property Capital Returns for Japan, Korea, Singapore* and Australia (2010-2022)



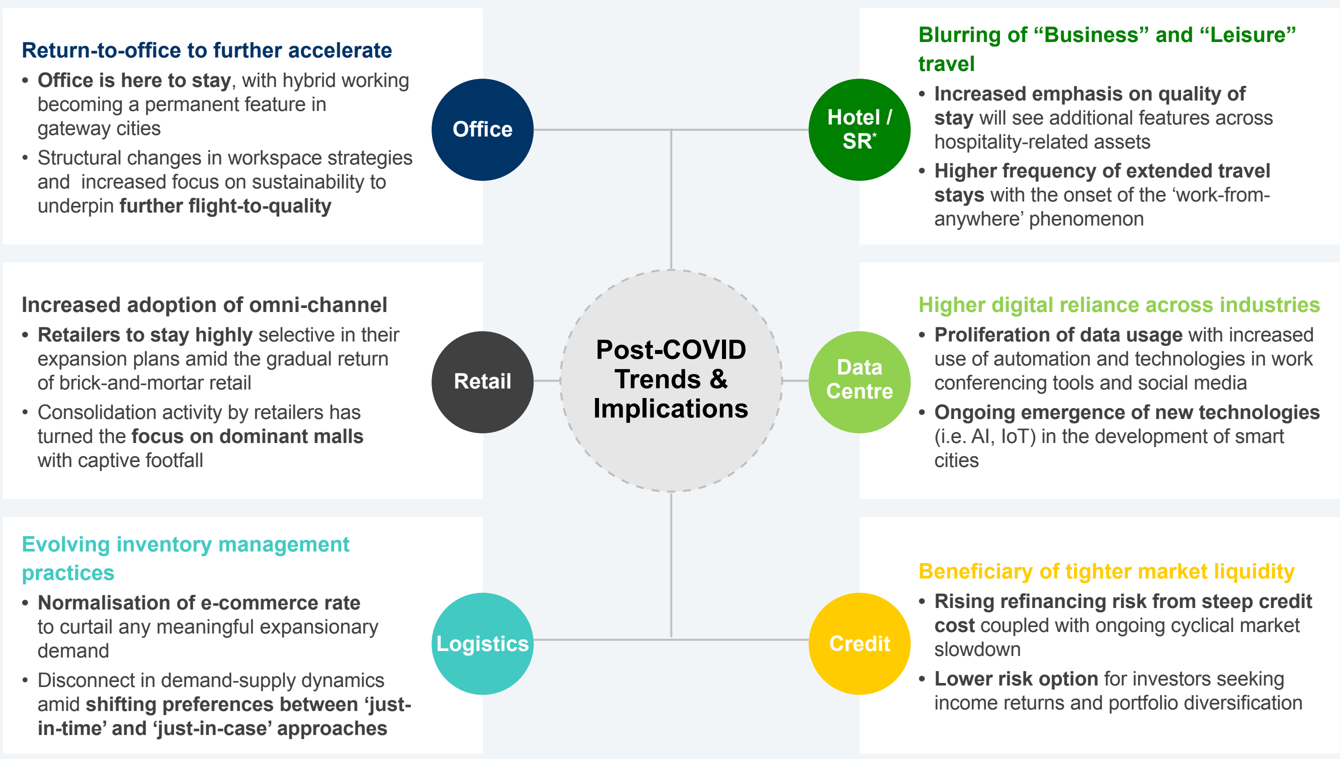
Source: MSCI Real Assets, CLI Group Research, May 2023
*Data for Korea and Singapore is released on an annual basis.

THE COVID-19 RIPPLE EFFECT

The reality that will unfold after the COVID-19 pandemic is still being played out. Much like a testbed of ideas, certain 'new normalities' have had more permanence than others: the dearth of the office, for example, has not materialised, as employers and employees embrace working in the office to varying degrees. Conversely, other trends such as heightened hygiene and wellness factors in the hospitality sector, have enabled operators with the highest standards to differentiate themselves and gain a competitive edge (Figure 6).

Operators with a strong track record and differentiated strategies withstood COVID-19 and emerged as industry leaders. Having shored up reserves as their peers rebuilt post-pandemic, they will be instrumental in driving underlying income streams in the future.

Figure 6: Post-COVID Trends & Implications for the APAC Real Estate Asset Classes



Source: CLI Group Research, May 2023
*SR denotes Serviced Residence.

RE-EMERGENCE OF CHINA

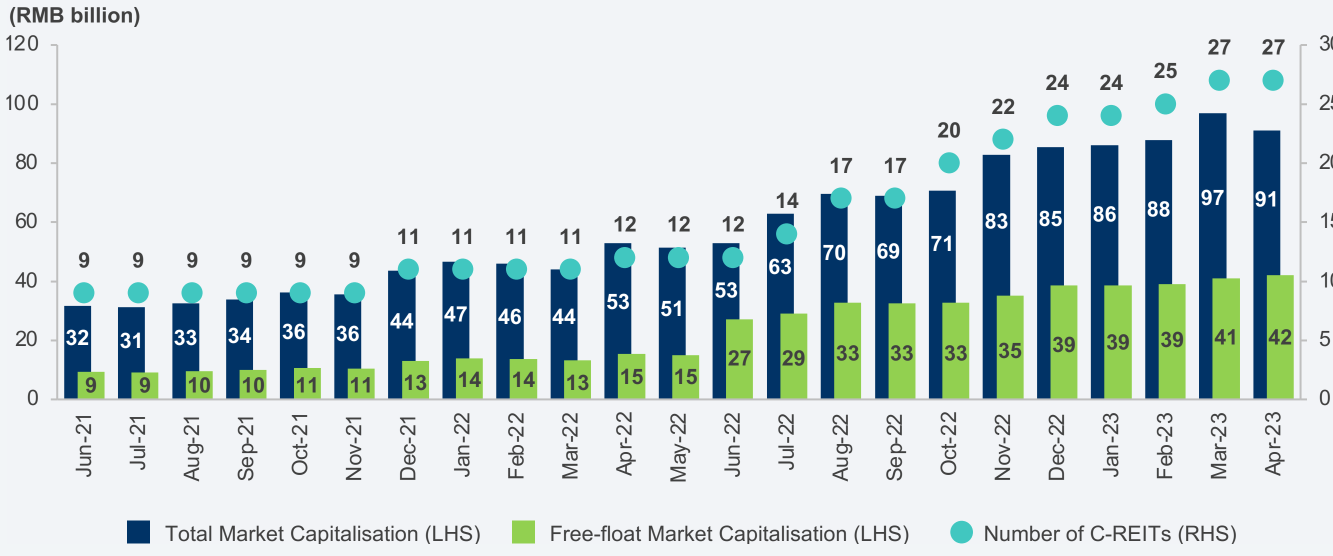
Regional economies had high hopes for China's much anticipated re-opening in December 2022, but the pace of recovery may vary across the APAC cities. The first noticeable beneficiaries will be the hospitality and retail sectors, as consumers relax their grasp on previously pent-up consumption.

The 'Two Sessions'[12] meeting in March 2023 reinforced the Chinese Communist Party's authority in the Finance and Technology sectors, with an increased focus on self-sufficiency in critical infrastructure and technology. In line with the current five-year plan, inward private direct investment and domestic consumption were identified as the top growth drivers.

This has already had interesting repercussions on real estate as highly targeted policies, including the comprehensive 16-point playbook[13], have since been enacted to support developers, financial institutions, and homebuyers. While policy easing is critical to upholding the property sector, the nature of fiscal policies will require patience, so much so that an 'L-shaped recovery' could well be on the cards.

Additionally the unfulfilled funding gap will offer a steady and varied stream of opportunities for institutional investors across real asset types and the full capital stack in the next couple of years. Value-seeking investors should explore innovative investment strategies and products such as China REITs (C-REITs) (Figure 7), domestic funds and alternative investment products that have been issued in tandem with the 'transition to market'[14].

Figure 7: Number of C-REITs and Market Capitalisation



Source: Wind, CLI China, May 2023

3. Structural Demand Drivers Stand Strong

APAC TO DRIVE GLOBAL MIDDLE CLASS POPULATION GROWTH

The COVID-19 pandemic and ongoing macroeconomic slowdown have done little to deter the urbanisation and dominance of middle-class households in APAC (Figure 8). Post-pandemic, longer-term demographic trends remain intact and continue to shape the economy and society at large.

The rise of the Millennial and Gen Z populations is dramatically reshaping APAC's economy. The proportionate growth of this notoriously tech-savvy generation in APAC is set to outweigh that in any other region, and the changing preferences and expectations of this segment are likely to result in fundamental changes in consumer behavior and shape the way businesses operate.

In addition, APAC will see the strongest shift in urbanisation worldwide. China, India and Southeast Asia[15] are set to lead the charge, further compounding the potential demand for real estate and infrastructure investment in the process.

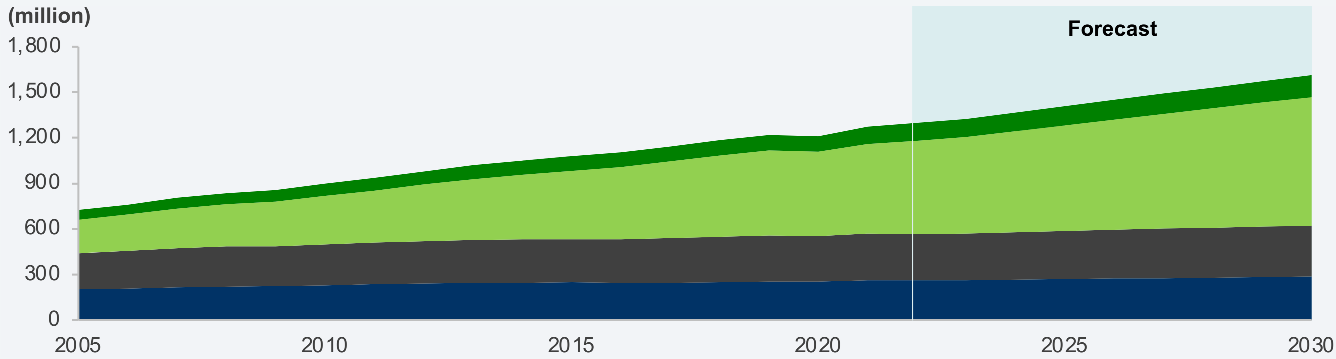
12 The collective term for the Chinese government's annual plenary sessions of the National People's Congress and of the Chinese People's Political Consultative Conference.

13 The Chinese government outlined a 16-point policy plan in November 2022 to inject market liquidity and stabilise the nation's property sector. These measures included credit support for developers, financial support to ensure completion and handover of projects to homeowners, and assistance for deferred-payment loans for homebuyers.

14 The 'transition to market' refers to the ongoing process of liberalisation and reform in China, which has led to the emergence of new investment opportunities and financial instruments.

15 Average annual urban population growth is projected at 13.8 million in China, 9.7 million in India and 7.4 million in Southeast Asia over the period from 2023 to 2030. Source: World Bank, Oxford Economics, CLI Group Research, April 2023.

Figure 8: Total Middle Class* Households – by Region



Growth between 2023 to 2030

Americas	Europe	Asia Pacific	Africa & ME
26 million	29 million	232 million	27 million
10%	9%	38%	23%

Source: Oxford Economics, CLI Group Research, May 2023
*Middle class is defined as households that have an annual pre-tax income greater than US$20,000 (in PPP Constant 2015 Prices); Based on the 164 countries tracked by Oxford Economics with available data.

On the other hand, there is the growing 'Lonely Economy' phenomenon, which has been fueled by increasing social isolation, the shift from in-person to tech-enabled engagement and a decline in traditional community and family structures due to ageing populations and lower fertility rates.

This trend has significant implications in many major economies. In China, for example, whilst workforces and household sizes have become smaller, the prevalence of technology, robotics, healthcare needs and liabilities has not. The incremental demand from these ongoing societal changes is therefore likely to benefit sectors such as coliving, multifamily, data centres, modern logistics, and self-storage.

SUSTAINABILITY IS AN IMPERATIVE

Sustainability in real estate is no longer simply a trend across the APAC region. As governments, corporates, investors and financiers have increasingly recognised the importance of sustainability in industry innovation, the environment and the economy, they have become more committed to sustainable practices. This has led to a greater emphasis on sustainable development and the widespread use of green technologies and practices in real estate.

There is a growing need for greater transparency and disclosure around environmental risks and impacts, which can otherwise act as a disincentive to corporates. Additionally, tenants and investors are mandating sustainable and green buildings in their portfolios, with investors placing greater emphasis on sustainability metrics in their investment decisions.

This paradigm shift is driving the development of sustainable financing instruments, green-rated assets and real estate funds, renewable funds, and climate-tech funds.

A MEASURED APPROACH TO FINDING OPPORTUNITY IN VOLATILITY

The real assets investment landscape is riding a wave of unprecedented volatility, which, coupled with heightened interest rates and inflation, has led to a perfect storm of uncertainty. APAC may have many strings to its bow, but it is vital that investors consider the unique risks and challenges of the region, such as political and economic instability, regulatory uncertainty and cultural differences. One particular challenge is the risk of cap rate decompression in 2023, which is especially relevant in the current market backdrop, where real estate valuations reached cyclical highs in recent years and are declining toward long-term and expected levels.

In this paper, we have explored **the richness of APAC and the many opportunities that exist for investors** with varied risk and reward appetites and investment horizons. Present market dynamics may represent unchartered waters for even the most seasoned of investors, but **APAC has proven time and again its flair for reinvention** and **presenting opportunities in the most challenging of markets**.

About CapitaLand Investment Limited

Headquartered and listed in Singapore, CapitaLand Investment Limited (CLI) is a leading global real estate investment manager (REIM) with a strong Asia foothold.

As at 31 March 2023, CLI had S$133 billion of real estate assets under management, and S$89 billion of real estate funds under management (FUM) held via six listed real estate investment trusts and business trusts, and more than 30 private vehicles across Asia Pacific, Europe and USA. Its diversified real estate asset classes cover retail, office, lodging, business parks, industrial, logistics and data centres.

CLI aims to scale its FUM and fee-related earnings through fund management, lodging management and its full stack of operating capabilities, and maintain effective capital management. As the investment management arm of CapitaLand Group, CLI has access to the development capabilities of and pipeline investment opportunities from CapitaLand's development arm.

As a responsible company, CLI places sustainability at the core of what it does and has committed to achieve net zero emissions by 2050. CLI contributes to the environmental and social well-being of the communities where it operates, as it delivers long-term economic value to its stakeholders.

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