Research Blast

Asia Real Estate Market, Brexit Update July 2016

Brexit: The Asia Pacific perspective

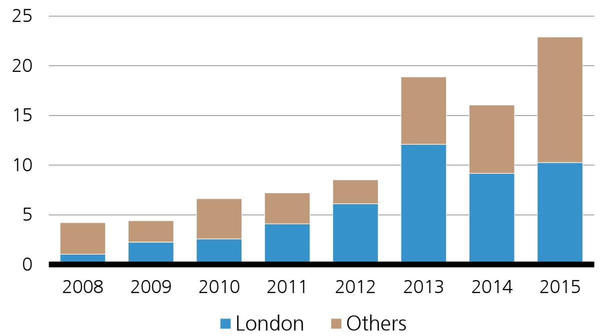
Coming to terms
As investors come to terms with the outcome of the UK's referendum on its EU membership, the vote to exit will have implications for the global economy and financial markets. Investors should brace themselves for a period of heightened volatility by taking advantage of selective opportunities and positioning their investment strategies accordingly. The increasingly interlinked nature of trade, financial markets and capital flows dictates that Asia Pacific (APAC) will not be a bystander.

In line with the views of our European research team, the extent of the impact on real estate markets from the Brexit outcome will take time to unfold, given the uncertainties around when Article 50 of the Lisbon treaty is triggered by the UK government, subsequent negotiations with the EU over the following two years (which can be extended by a further two years under certain circumstances) and finally the UK's ultimate relationship with the EU and other key governments.

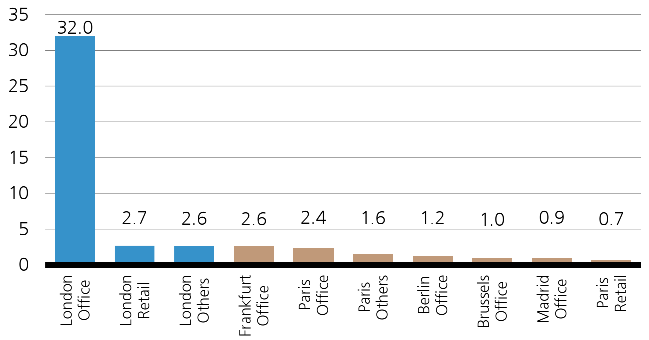
One thing is for sure – what happens in the UK does not stay in the UK. The immediate kneejerk reaction has been a retreat by investors to 'safe haven' assets such as gold and government bonds, and the USD, CHF and Yen currencies, although the initial pullback in global risk aversion has subsequently reversed itself somewhat. Investor sentiments often over-react to market shocks, and the UK is facing some immediate pressure as retail investors look to reduce their real estate positions in 'retail' funds.

Asia Pacific is not a courtside spectator
Outbound capital from APAC: Since 2010, there has been a surge in capital from APAC into European real estate. Between 2010 and 2015, more than USD80 billion was invested into direct European property (excluding investments through comingled funds) as APAC investors took advantage of attractive entry points and elevated yields in the aftermath of the financial crisis. China's credit injection in 2009 also played a role in these outbound capital flows as regional investors found themselves with ample liquidity.

Capital from APAC into Europe real estate
(USD billion)



Capital from APAC into Europe - 2010 to 2015
(USD billion)

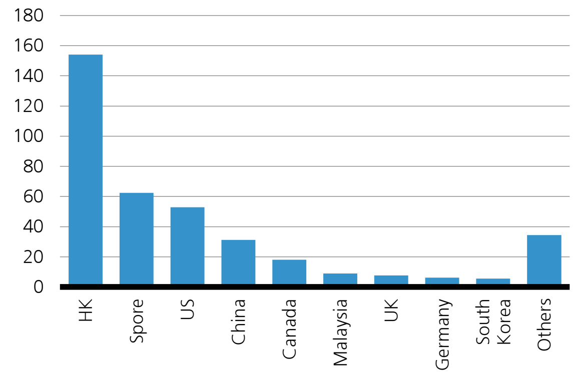


Source: Real Capital Analytics (as at June 25, 2016)

More than half of this outbound APAC capital was invested into London. This capital has been disproportionately invested into the London office market, of which the City may take the hardest hit from the Brexit shock, given that some financial sector jobs and capital spending may be diverted to other European financial centers and / or disappear altogether. To some extent, any downward pressure on pricing will be capped by the decline in government yields.

The fall in value of the Pound sterling further undermines existing real estate investments particularly for USD denominated investors. Conversely, it also creates potential pricing discounts for opportunistic capital that can see beyond the near to medium term uncertainty. The same argument was put forward as a driver of foreign capital flows into the prime central London residential and prime office markets in 2009.

Global capital into APAC - 2010 to 2015
(USD billion)



Source: Real Capital Analytics (as at June 25, 2016)

Institutional investors including pension, savings and insurance funds in Asia which have been allocating more capital towards real estate and were active or becoming active in European markets, may now reassess whether their initial and potential investments are still aligned with their long term income generation and capital preservation goals. We may see some Asian capital moving into other key European and global financial centers, although this would depend on the overarching appetite for risk.

Lower (for longer) interest rates are also expected to support relative value and a flight to quality, and opportunistic long term money from APAC may still be inclined to look through the current turmoil and focus on UK assets with strong covenants and long lease terms.

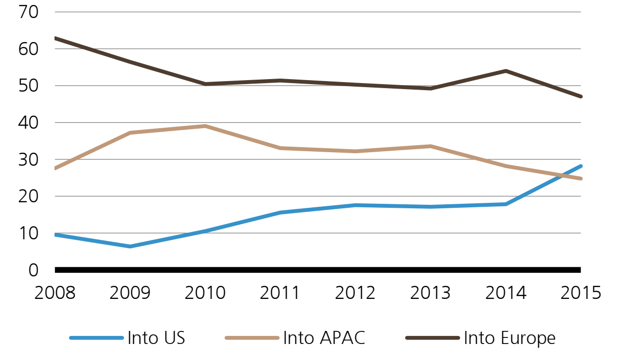
<u>Inbound capital into APAC:</u> Between 2010 and 2015, more than USD 382 billion was invested into APAC real estate, mainly driven by Hong Kong, Singapore, China and North America. It is obvious that while a significant amount of APAC capital had been deployed into Europe, a much more substantial volume has found its way into the Asia region, primarily into the deeper markets of Australia (Sydney and Melbourne), China (Shanghai and Beijing), Japan (Tokyo) and Singapore.

Our general view is that global capital will pause and wait for the dust to settle before we can observe any tangible effect on pricing and capital movements across real estate markets. We foresee a retreat of investment interest back into domestic markets, as heightened risk aversion leads to a pullback in intra-regional capital flows. To that end, it is likely that APAC real estate, especially developed markets such as Australia, Japan, Singapore and Hong Kong, will be net marginal beneficiaries.

How will APAC be affected?

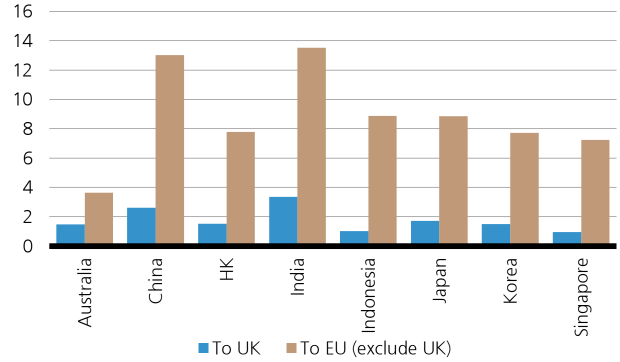
1. **Trade:** Regional trade linkages to the UK are limited, with most major Asian countries exporting less than 3% of their total exports to the UK in 2015. However, the same cannot be said for continental Europe, with China and India particularly vulnerable to a pullback in EU growth. Although less exposed than China, Japan's exports and corporate profits may come under pressure on account of its strengthening currency as investors seek safety in the Yen. However, in a scenario where external demand slows considerably we would expect key APAC central banks to ease monetary policy further which should provide some support for domestic demand.

Capital flows into real estate by region
(in %)



Source: Real Capital Analytics (as at June 25, 2016)

Percentage of total exports in 2015
(in %)



Source: CEIC (as at June 25, 2016)

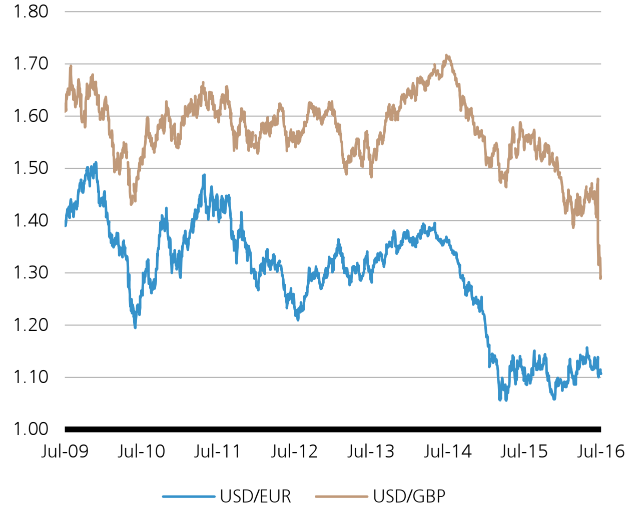
2. **Financial linkages:** Financial stress as a result of elevated global uncertainty and pullback in market liquidity is reverberating across the APAC region. Asian emerging economies such as Malaysia and Indonesia are particularly exposed. However, the overall fallout for the APAC region is likely to be limited given falling long term interest rates tend to soften any slowdown in credit growth by reducing the debt servicing costs for existing debt with floating interest rates and new debt. In addition, excess savings suggest that domestic financial systems maintain sufficient liquidity to cover borrowing needs which ensures that regional economies are less vulnerable to swings in global risk appetite.

3. **Interest rates:** The Brexit shock has clearly provided renewed impetus for government bonds markets, with yields for key developed markets falling sharply since the vote. Against the backdrop of weaker growth and heightened risk aversion, the 'lower for longer' interest rate environment is becoming ever more difficult for central banks to break.

   Major central banks are likely to delay any planned rate hikes or engage in further monetary easing, notwithstanding the marginal efficacy of policy easing has been muted in recent years. The US Federal Reserve is likely to postpone its rate hiking posture for the foreseeable future. The real estate markets of Hong Kong and Singapore are likely to be key beneficiaries of this stance as lower rates provide support for real estate transactions despite pricing looking expensive on a historical basis. In other parts of Asia, although yields for core assets are already below peak levels, such as in Japan and key Australian markets, lower interest rates will be a boon for real estate yield spreads. Arguably, on a risk-adjusted basis, APAC real estate can bolster its position as a relatively higher yielding asset class in a lower yielding world.

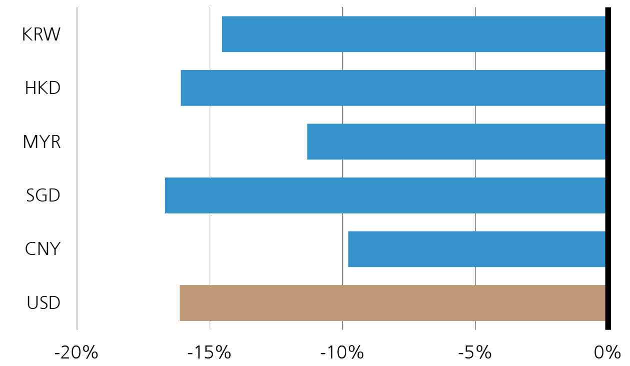
4. **Currency:** At the time of writing, the pound has fallen to a 31 year low against the greenback. It has also hit historical troughs against major Asian currencies such as the Chinese RMB, the Singapore dollar, Korean won, Hong Kong dollar and the Japanese yen. Asian owners of UK real estate are sitting on significant paper losses when translated back into their reported currency. The amplifying effects of leverage and any capital value deterioration as occupier and investment markets adjust to the near term growth pullback will add to the pain. For those Chinese investors that aggressively purchased UK assets this will represent a large hit to their portfolio values and a pullback is likely as they look to the US or retreat back to the APAC region, at least until there is more clarity on pricing, growth prospects and the political environment.

USD/EUR & USD/GBP



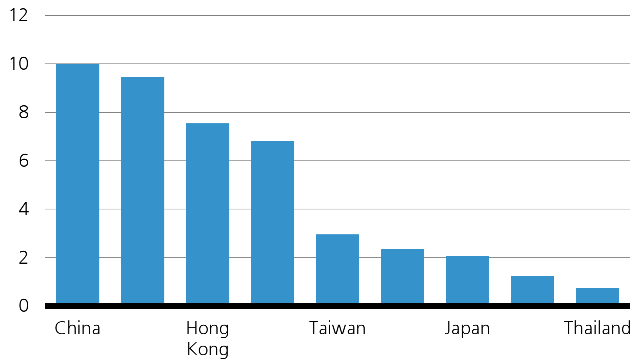
Source: CEIC (as at 8 July 2016)

GBP vs major currencies
(YoY as at July 7, 2016)



Source: CEIC (as at 8 July 2016)

APAC sources of investment into UK - 2010 to 2015
(USD billion)



Source: Real Capital Analytics (as at 26 June 2016)

Conclusion

In the near to medium term, there is likely to be a general pullback in intra-regional capital flows as investors retreat to their regional and domestic markets. In this context, outbound APAC capital will now become more discerning and likely to focus on curbing leverage, limiting exposure to cities with large financial services sectors, and gaining access to assets with long weighted lease expiry schedules. On the other hand, APAC real estate may be a key beneficiary as inbound capital seeks relative economic growth and yield potential. The socio-economic and demography story stays intact and this relative political stability will perhaps be a key driver of capital flows into Asia real estate, with developed Asia benefitting in the near term, and emerging Asia such as China, India and Vietnam coming up strongly over the medium term as their real estate markets continue to mature.

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