Asia's promise

Four trends driving real estate in the region

by Brian Chinappi

The COVID-19 outbreak has brought about significant change and disruption to the world's economies, and there is no doubt many sectors and markets will feel substantial pain as a result of the pandemic, at least over the short term. But as we live through these extraordinary times, four major trends driving real estate — demographic shifts, deficient supply, digital disruption and demand for yield — remain as relevant as ever in Asian growth markets. And as with any shock, investment opportunities remain in areas underpinned by long-term fundamentals — and in our view, Asian real estate is one such opportunity.

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Although the global economic backdrop looks challenging, as before the current crisis, we believe significant opportunity remains in many of Asia's major cities in markets such as China and South Korea — both of which were exposed early to the virus and have worked quickly to contain it — as well as in India and across Southeast Asia. Because major cities have large economies, a deep pool of middle-class residents, and high-quality, often very modern, infrastructure, they will continue to benefit from strong medium- to long-term growth and have the potential to offer strong returns.

Driving these returns are four consistent themes that will continue to underpin demand and, therefore, value. In many instances, these secular tailwinds have even strengthened as a result of COVID-19.

1. Demographic shifts

The first theme is demographic shifts. Rapid urbanisation is an important part of this, with an estimated increase of more than 20 percent in urban populations in the decade to 2020, according to the United Nations. Yet more significant is the increasing concentration of wealth in the region's cities. With the World Economic Forum predicting Asia will account for 90 percent of the next billion people entering the world's middle class, it's clear, across most sectors, emerging Asian real estate markets will benefit from increasing disposable incomes and demand for improved built environments like nowhere else.

Indeed, emerging Asia is home to some of the few markets in the world where affordability in the housing market is increasing as a result of high wage growth. The rapid decline in poverty rates in Vietnam, for example, from more than 70 percent in 2002 to less than 6 percent in 2018, according to World Bank figures, means affordability in Ho Chi Minh City is on the up, as is the case in Indian cities, such as Pune and Bangalore. At the same time, the pressing need to house the growing numbers of middle-income residents in cities across the region — especially urban high-density accommodation that can be delivered cost-effectively to target those in the 50th to 70th percentile of local incomes — is creating significant demand for truly affordable residential property.

2. Digital disruption

Digital disruption is another major driver. The rapid adoption of smartphones across Asia resulted in the region being home to some of the most digital-savvy organisations and consumers on the planet, and the increased demand for digital services

through the COVID-19 outbreak is likely to underscore this further. Major Asian markets saw a 50 percent compound annual growth rate in data usage in the 10 years to 2020, according to PwC. This is prompting significant demand for data centres in markets such as China — demand that looks set to increase further following the outbreak, as businesses and consumers shift even more towards digital solutions. Our investment Chayora Holdings, for example, is helping develop world-class data-centre infrastructure to facilitate web-based services, such as cloud, banking, e-commerce and content streaming. Our most recent funding round for the business, made in late 2019, provides expansion capital for a hyperscale campus in Tianjin, China, as well as to acquire a land bank for further growth in Tianjin and Shanghai.

Allied to the adoption of digital technologies is the growth of online retail across the region, a trend that has also strengthened as a result of COVID-19. The sector clearly requires the development of e-commerce logistics centres close to major cities. Before the outbreak, Credit Suisse estimated Asia would need to double the amount of logistics space it has by 2022 to keep up with demand. Online retail growth across Asia will have grown tenfold in the decade to 2020, according to Euromonitor, and this is driving demand for omnichannel space and warehousing.

The trends of digital disruption and stress in sectors such as retail are being accelerated by the effects of COVID-19 social-distancing measures. This clearly affects existing real estate stock across Asian growth markets, much as in developed markets, but there are important differences. While in the United States a retail repositioning strategy can present challenges, in that regional malls often don't have a sufficiently large catchment area to make them viable, in Chinese tier 1 cities, often upwards of 500,000 people will be within a three-mile (4.8-kilometre) radius. Even before the emergence of COVID-19, China was experiencing a slowdown in its real estate market — the result of the deleveraging process happening in the country, as well as the effects of the trade war with the United States. Some real estate owners are now facing financial stress, bringing assets in tier 1 cities on to the market. These factors create significant potential to buy assets, such as retail malls, at an attractive price and reposition them so they provide a range of services that better meet the needs of local populations, from dining and entertainment through to education and healthcare.

3. Deficient stock

Such repositioning opportunities also link into the third driver of demand: a mismatch between existing space and what users need and can actually afford, or what we term deficient real estate supply. In many markets, developers have focused on creating grade A space, building an oversupply of this class of real estate when what the market needs, particularly following an economic shock, is something of quality that is also cost-effective. In other markets, existing space has become obsolete, so new institutional stock is needed.

Although these four drivers demonstrate significant headroom for Asian real estate investment, execution capability is vital.

This was one of the major factors in our investment in Young City, a development of more than 99,000 square metres of high-specification office space in the southwest of Seoul. When we analysed the market in 2014, it was clear there was an oversupply of grade A office space, with vacancy greater than 20 percent. We could also see, however, there was an undersupply of decent and fit-for-purpose back-office space — these functions were often housed in old stock with small floor plates and stratified ownership. We understood if we could build a high-quality development in the right location and offer it at affordable rents, demand from business tenants would be strong. Having identified a site that was well connected but underdeveloped, we acquired it in an off-market process from a government agency. Partnering with Korean conglomerate SK D&D, and consulting with local businesses to understand their needs, we developed 1 million square feet (92,903 square metres) of back-office space created to meet end-users' requirements. Completed in 2017, the building is now 98 percent leased, with both local and international tenants attracted to the building's modern, spacious and sustainable design, and cost-effective rents.

4. Demand for yield

The final driver is demand for yield at a time of persistently low interest rates in many markets across the world, with a long-term trend among global investors seeking high-quality real estate investments to generate returns. Asian institutional investors are still relatively new to real estate investment and, therefore, have a low current exposure. As a result, we expect local investors will pick up the pace once economies have absorbed some of the COVID-19 shock. Yet while the demand will continue to be there, supply remains short, with few high-quality institutional assets trading hands.

Investors able to build high-quality core real estate, or reposition existing assets effectively to create attractive spaces that meet the needs of a modern economy and generate a stable income, will, therefore, find significant demand among both local and international investors when it comes to exit. This is particularly the case because many institutions have a lower appetite for development and will be seeking ready-built core assets once demand recovers.

Strong execution capability

The ability to achieve results successfully, however, particularly in a challenging economic environment, requires significant local knowledge and know-how. Although these four drivers demonstrate significant headroom for Asian real estate investment, execution capability is vital. That means having local teams that can identify the right locations, understand the nuances of individual markets, and have the relationships and credibility to partner with operators that have a track record for delivery on time and to budget. At Actis, we have recently made an investment in a logistics venture in China, for example, in which we have teamed up with a partner who is new for us but whose founder we have known for more than a decade. The investment marries our view of the most promising locations and sectors with the operational capability of our partner.

Successful outcomes also require a focus on responsible investing to ensure health and safety on site and in worker accommodations meet international standards, local community needs are met, and buildings meet sustainability standards. Tenants and investors are increasingly seeking buildings that can help them meet their own environmental goals.

It's clear there is still significant opportunity in real estate investment in major Asian cities. While we may be seeing a current slowdown in demand, we are confident this will recover. Indeed, the situation strengthens many of the tailwinds behind our strategy, which is characterised by a focus on affordability, partner quality and modest leverage to future-proof new and existing investments. Also important is having a local presence to remain vigilant to new opportunities and identify trends around the pace and timing of the recovery. ❖

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