

The real estate opportunity in Asia

Reno Sio, Institutional Real Estate, Inc's managing director, Asia Pacific, recently spoke with **Brian Chinappi**, partner and head of real estate with Actis, about strategies for real estate investment in Asia. Following is an excerpt of that conversation.

Why Asia right now? What is the current state of the real estate sector in Asia?

There are a handful of reasons a global investor would want to come to Asia. The first is the fact that the global themes driving the new economy in the West have a stronger presence in Asia due to fundamentally stronger, longer-term, secular demand trends. Secondly, Asia is dealing with fewer structural changes related to the "use case" for real estate. The key concern dominating many of the more developed markets is remote work and the question around the future of office. How that settles will be a meaningful driver of what's happening in real estate in some of the bigger US cities and, to a lesser extent, some of the bigger cities in Europe. If the work patterns are fundamentally changed, that has ramifications for all sorts of real estate. There will be winners and losers, whether they be the retail in proximity to office, the change in transportation patterns that impact the value of real estate, or housing. Then you have the tax implications, particularly in the United States, where certain states are competing for tax revenue and, therefore, impacting interstate migration. Asia does not have any of these issues. The third reason is that the availability of cheap and/or abundant leverage has not been a significant driver of returns or valuations in the growth markets in Asia. This results in more defensive investment performance through cycles.

Finally, there is diversification. For many of the reasons cited above, the recent performance of real estate in Asia has been markedly, and positively, different from many developed markets. While exceptions will always exist, having a diversified portfolio in Asia is important to achieving this goal of more global diversification. Currently, we think about the growth markets in Asia divided into two categories. We have the benefit of markets, such as South Korea and China, where there is currently some stress, even some distress, which could provide a repricing opportunity. The repricing may not be to the extent some expect to see in the West, but we do expect it will provide some better future points of entry into structurally sound markets. Then we have markets, such as India and across Southeast Asia, which are in more of a growth mode. So across the region, Asia offers quite a bit of diversity.

What global themes are affecting real estate investment?

We focus on four global themes: digitalisation; supply-chain transformation; health and wellness; and climate transition. We believe these themes are as dominant and durable in Asia as they are elsewhere. In Asia, however, these themes are accentuated by three secular demand trends. The first is demographic shifts – not simply urbanisation, but the densification of wealth in cities. The second is deficient supply. The existing property stock is undersupplied to support the demand or, more likely, of insufficient quality or affordability to support the demand. The first two demand drivers are important for generating income, which ultimately drives real estate value. The third demand driver, which we refer to as demand for yield, drives the exit. In Asia, we still benefit from the fact that local institutional capital is still largely in its early

days with respect to using real estate as a long-term institutional asset class. We have experienced, even when it doesn't seem to be the most opportune time to be selling assets, if you have a strong income-producing asset tilted towards serving these themes and demand, there is significant local institutional capital interested in buying these assets.

What do you mean by "new economy" real estate?

Our definition is real estate that sits right at the convergence of the themes and trends we just spoke about. More specifically, from a sector perspective, this has led us to focus on industrial/logistics, data centres, life sciences and urban repurposing. Urban repurposing is the opportunity that arises from the fact that many early-generation properties in our dense urban centres are often not fit for new-economy uses, resulting in redevelopment opportunity. These sectors also share some commonalities that help us drive value – whether it is similar development processes, the need to be providing corporate solutions, build-to-core exit strategies, or the importance of sustainability.

How should investors in the West weigh the diversification benefits of investing in Asia against the hedging costs, currency depreciation and other costs of investing far from home?

With respect to foreign-exchange risk, there is no silver bullet. We don't hedge, but we underwrite and mitigate in several ways. Some of the most important ways are financing in local currency, procuring build cost locally, and targeting local demand for tenancy and exit. In our experience, this reduces any dollarisation within the investment itself. We then underwrite for prevailing views of local currency depreciation during our holding period.

Using this strategy, we have been able to deliver strong US-dollar results from Asia during more than 10 years, both on an absolute and risk-adjusted basis, given our lower use of leverage than is often typical in more developed markets. This is perhaps even better demonstrated in this current cycle when many developed markets have been highly impacted by the interest-rate cycle and high dependence on leverage. Not limited to Asia, but going forward, I expect there will be a greater appreciation for returns that are driven by actually adding value and operational capability, versus leverage and financial engineering.

You mentioned adding value operationally. Can you address the operational side of the business?

We are builder-operators in everything we do. Operational competency has always been important to us. We believe you need to have a fundamental understanding of how real estate is developed, constructed and operated, which becomes even more critical as you move into some of the more specialty assets. Our properties become essential to our corporate tenants, and these corporates need to feel confident you can deliver the asset on time and provide an operating environment for them that is specifically suited for their needs.

To deliver this operational capability, we have three strategies in our playbook. First, we joint venture with high-quality operating partners on the ground, and we work with them on a fully aligned basis, with us having at least 50 percent control, to help us together deliver outcomes and manage risk in that market. This

is typically with respect to single-asset investments, and we've done about 30 of these joint ventures in the past approximately 10 years. To do this consistently and successfully with a quality partner, you need to be able to prove to them that you're much more than just a financial investor. The second strategy is creating programmes with those partners. Here, there is a deeper ambition than a single asset, so we'll put a strategy around it and pursue multiple assets, perhaps across multiple cities in a market with that partner. The third strategy involves building our own platform – a fully integrated business that is developing, acquiring and operating real estate. We build integrated businesses when having internalised operations is critical to attracting the targeted demand, and often time, there's an inextricable link between the asset and the operating capability for that asset. In these instances, we will either buy an existing management team that wants to grow or institutionalise their business, or we'll build a team from scratch, hiring a CEO, CFO, COO, key heads of departments, etc. We'll put the whole team together, person-by-person, to build a business. Again, for us to be able to attract the management team or hire high-quality people, we need to demonstrate that operating capability.

How does your sustainability approach play out in your real estate business?

We have made several sustainability commitments for everything we do in the real estate space. First, we conduct an asset-specific sustainability review, which covers environmental aspects, such as embedded carbon, procurement issues, energy management and carbon reduction, as well as resilience. From that broad review, we will decide what we must do, what we would like to do based on cost-benefit analysis, and where can we raise the bar in a market. The second commitment we've made is to seek an environmental rating for all our assets. Ideally this is an international rating, but in some instances, domestic. The third commitment relates to procurement. A lot of the focus in real estate is on how you manage an asset after it's built, but the biggest carbon impact is actually building the asset. Reducing the embedded carbon in the development process is an important way to make an impact. Local procurement helps with both sustainability goals and cost management.

Our fourth commitment involves upholding the highest governance best practise, and our final two commitments – promoting inclusion and diversity and implementing local

skills-training programmes – are equally meaningful but deliver the most significant impact when we are platform building and have direct control over management.

How do you measure the cost-value benefit of your sustainability efforts?

There is ample evidence that not focusing on sustainability will be damaging to an investment – whether it is related to obtaining necessary government support and approvals, earning a "licence to operate" with various stakeholders, or being attractive to the target tenants and longer-term owners of the asset. Any significant corporate has its own sustainability commitments, including net-zero carbon emissions commitments. If you're not part of that solution for them, you're going to be left behind. Sustainability is around whether you're going to have a tenant and whether you're going to eventually be able to sell the asset. To us, sustainability equals value; it's the fact that you actually own a durable long-term asset.

At Actis, we are forthright in our belief that values drive value – our focus on sustainability is not driven merely by the fact that it is the "right thing to do" but because it is a commercial imperative.

When do you see the lowest point in the market, and when do you see recovery coming?

Each market and each sector within each market is very different. As I mentioned previously, our markets are mixed between those more linked to the global interest-rate cycle, such as South Korea; those more dominated by their domestic economy and geopolitics, such as China; and those that continue to exhibit rather strong growth, such as India and parts of Southeast Asia. The diversification in Asia is such that, even within a market, some parts are more highly linked to the global economic cycle, and others are dominantly domestic driven. We believe this is a good thing and why investment decisions cannot be based on headline news. It's obviously impossible to know when we have hit the lowest point in any market – however, some key signposts for us will be the trajectory of US interest rates, China-related geopolitics and regional growth outlooks. Ultimately, the best way for investment decisions to remain defensive through cycles is to double down on durable themes, strong secular demand trends, operating capability and strategies where leverage is not the primary driver of returns. This has served us well in the past, and I expect will continue to do so going forward.

CONTRIBUTOR



Brian Chinappi
Partner and Head of Real Estate

Based in Hong Kong, Brian Chinappi heads up Actis' real estate business, leading a team of investment professionals focused on delivering returns through understanding micro-market dynamics and emphasising strategic, hands-on operations and management. Under his leadership, the business has invested across both the traditional and alternative property sectors and has demonstrated an ability to identify secular trends, to position itself for first- or early-mover advantage.

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CORPORATE OVERVIEW

Actis is a leading global investor in sustainable infrastructure. We deliver competitive returns and measurable positive impact for the countries, cities and communities in which we operate. Our global experience, operational know-how and strong culture allow us to create global sustainability leaders. We do it at scale, and we have been doing so for decades. Since inception, we have raised US\$25 billion to invest in a better tomorrow.

Actis' Asia real estate business invests across greater China, India, South Korea and Southeast Asia, investing with, and providing strategic value to, high-quality operating teams and partners, across diverse property types. Actis' build-to-core strategy continues to capitalise on the mismatch between the demand and the quality and affordability of existing supply. Our local teams identify where this demand is not being met and deliver the desired product at an affordable price and, thereby, create an attractive core asset.

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