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Strategy Flash

Why Asia Pacific Commercial Real Estate in 2022?

Summary

- Real Estate as an asset class is a good inflation hedge and an effective diversification tool in a portfolio.
- On-going e-commerce trend is creating structural demand for Industrial/logistics facilities/properties and the ESG trend is ushering in a growing demand for green offices/ buildings.
- Asian commercial property is set to benefit from re-opening, attractive yields, and increasing intuitional investor demand.

Real Estate as a good inflation hedge & diversification tool

Conventional wisdom tells us that real estate performs well in an inflationary environment. This held true in 2021 as US REITs gained 41.3%, significantly outperforming the S&P 500 (+26.9%).

With global inflation staying higher for longer, we expect inflation concerns to take the driver's seat of financial markets and real assets to outperform this year, as a result.

It is interesting to note that while REITs show a high correlation with equities (0.87), direct real estate is negatively correlated to equities (-0.26) (chart 1). Hence, direct real estate is not only a good inflation hedge, but it is an effective portfolio diversifier too.

Industrial/logistics real estate is the golden child. But why?

1) The pandemic has accelerated the global expansion of e-commerce. This is expanding structural demand for logistics real estate including warehouses, distribution facilities and fulfilment centres etc. Demand appears "sticky" showing little sign of reversing as markets reopen.
2) With the broader adoption of 5G and the Metaverse, data centres, network towers and hi-tech industrial parks are primed for a record boom.

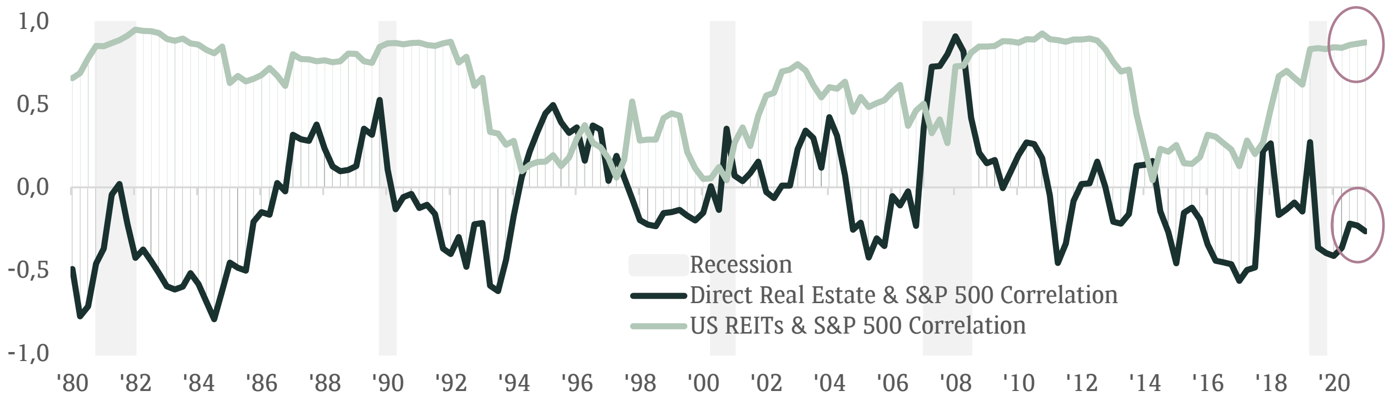
We have been seeing global real estate companies reallocating capital and restructuring their business to take advantage of these tailwinds.

Prashant BHAYANI
Chief Investment Officer
Asia
BNP Paribas
Wealth Management

Grace TAM
Chief Investment Adviser
Hong Kong
BNP Paribas
Wealth Management

Dannel LOW
Investment Specialist
Asia
BNP Paribas
Wealth Management

Chart 1: REITs are currently positively correlated to S&P 500 while direct real estate is negative correlated to US equities



Source: Bloomberg, BNP Paribas (WM), 14 Jan 2022
Note: 12-quarter rolling correlations, total returns of NAREIT, NCREIF & S&P 500
Past performance is not indicative of current and future performance

Office tenants commit to net zero carbon emissions targets

There has been increasing demand for "green" buildings due to rising global ESG awareness. Research has found that office tenants are willing to pay a 4-12% rental premium for the best sustainability-rated green offices to allow them to meet their own ESG targets.

Why Asia?

1) **The region is still in an early recovery phase** - With further progress in vaccine rollouts and new treatments available, we would see a further lifting of mobility restrictions and a reopening of economies in the Asia-Pacific region. The recovery of hotels, offices and retail property has been largely on track.

- Subsector-wise, **office** leasing volumes remain well below pre-pandemic levels, but are gaining momentum. Corporate occupiers from the tech (gaming and software development) and finance (insurance, wealth management and securities companies) sectors have relocated in order to to capitalise on cheaper rents, or to take advantage of facilities/ESG upgrade from new completions. In fact, several new office buildings in Singapore and India enjoyed high pre-leasing rates in 2021.

- While many large companies remain in cost-saving mode and are looking to reduce space, small- and mid-cap companies are seeking more space to improve social distancing. Furthermore, several major cities in India saw a strong recovery in office net absorption.

- The food & beverage sector continued to dominate leasing activity in the **retail** sector in H2 2021, while some luxury retailers were exploring upgrading opportunities in North Asian markets.

- Overall demand for **logistics/warehouse** in the region remains resilient, thanks to stringent requirements for safety inventory and omnichannel distribution by online retailers and related third-party logistics firms. Disruption in container shipping is accelerating the trend of occupiers to extend their distribution networks to last-mile facilities in order to shorten delivery times for consumers.

- A record high of around 172 million square feet of new logistics property supply is scheduled to be delivered in Asia-Pacific in 2022. The strong supply pipeline reflects the surging demand for space to extend logistics networks.

3) **Attractive yields** – In Asia-Pacific, the average yield of direct real estate is higher (4.6%) than its regional peers (Europe 4.1%; US 3.9%), and is more attractive than Global REITs (3.0%) and equity dividend yields (2.4-2.5%) (chart 2).

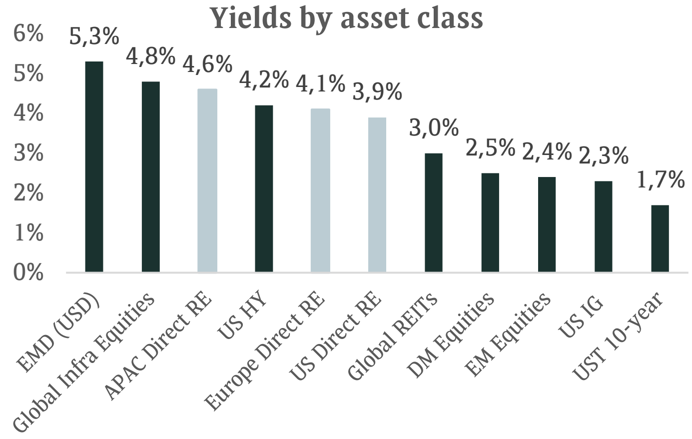
4) **Good portfolio diversifier** – Direct real estate in Asia-Pacific shows very low or even negative correlations to other asset classes (chart 3).

5) **Increasing demand for real estate from global institutional investors** – Pension funds, sovereign wealth funds, endowments and insurance companies are increasing their allocation to alternatives in their search for diversification and attractive yields. Asia-Pacific real estate is currently underinvested by these global asset allocators.

Concerned about interest rate hikes?

We should focus on property subsectors (industrials, logistics and offices) and selected properties with strong pricing power to pass through higher prices and rental growth to offset higher interest rates. Having said that, inflation is largely contained in some Asia-Pacific economies. We do not expect Japan to raise interest rates any time soon while China is set to cut rates further.

Chart 2: Direct real estate yields in APAC are attractive



Source: Bloomberg, JPMorgan, BNP Paribas (WM), 14 Jan 2022
Past performance is not indicative of current and future performance

Chart 3: Asia's direct real estate has a low/negative correlation to other asset classes

Asset class correlations	Global Equities	Global Bonds	Private Equity	Bitcoin
US direct RE	0.1	-0.1	0.3	0.3
Europe direct RE	0.3	-0.2	0.5	-0.2
APAC direct RE	0.1	-0.1	0.4	0.1

Source: Bloomberg, JPMorgan, BNP Paribas (WM), 14 Jan 2022
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CONCLUSION / STRATEGY

- We believe Asia-Pacific's commercial real estate, as an underowned asset class by global investors, will benefit from its qualities as a good inflation hedge, an effective tool for portfolio diversification and a higher yielder. The real estate asset class should benefit from a further reopening of economies in the region as well as the tech and ESG upgrade trends.
- We favour subsectors such as industrial, logistics and offices and selected properties/projects with accelerating rental growth and declining vacancy rates.

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