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Investment strategy 2018: It's all about alpha and alternatives

- Potential for further yield compression is limited
- Achieve alpha returns through "stock-picking" and active management
- Invest in alternative asset classes that ride on long-term fundamentals

High investment volume to continue

Global real estate investment volume in 2017 was higher than in the past ten years. Asia outperformed other regions with over 50% of global investment volume. Asian investors led the charge, accounting for over 50% of global volume. The investment momentum is expected to continue into 2018, spurred by global economic recovery and ample capital to be deployed.

Global economic recovery has become more broad-based, lifted by synchronised growth in advanced economies. Europe saw its best performance in 2017 since the global financial crisis. The US economy will get a boost from the recently passed tax reforms and increase in federal spending. In Asia Pacific (APAC), the Japanese economy has expanded for eight consecutive quarters. China's economy continues to grow at around 6.5% even as it curbs its property sector and credit growth. The export recovery in 2017 is now spreading to the services sector and domestic demand which will sustain further economic growth and confidence. This will in turn drive occupier and investor demand for space.

Economic growth will however likely be moderate, clouded by high leverage and uncertainties. Some of last year's uncertainties have abated, but others have resurfaced or accelerated. Key risks this year include a trade war, faster-than-expected pace of rate hikes, and a stock market collapse. We think they are unlikely to blow up given that there is great global apprehension on the consequences and therefore there will be cautiousness which in itself is a relief valve. It is usually the unexpected that will trigger a collapse in confidence.

Notwithstanding the uncertainties, a lot of money is still to be invested. Interest rates are rising, but from very low levels. APAC will also lag in the rate normalisation cycle. Japan is still struggling to raise its inflation rate. Most other APAC countries are keeping their rates low to maintain economic growth in the face of uncertainties. The main exceptions are China which is tightening credit to rein in leverage, Hong Kong where interest rates move in tandem with the US Fed rate to maintain the HKD peg and Singapore where interest rates are market-driven given its exchange-rate based monetary policy.

China's capital outflow restrictions mean no trophy acquisitions and more scrutiny on 'high-profile' companies, but other investments will continue, especially if they are related to the one belt one road initiative, or using monies already parked outside of China. There is also investment demand from non-Chinese investors. Insurance and pension funds are increasing allocation to real estate.

Limited yield compression

Despite the weight of capital, the potential for further yield compression is limited:

a) Yields have been compressing since the Global Financial Crisis to historical low levels. Capital values have risen faster than rental values;

b) There is some correlation between interest rate and yield movement. Our study showed a high correlation between Hong Kong's and Singapore's office yields and interest rates. Although the correlation was low in other markets such as Seoul and Tokyo as strong economic growth had kept yields low despite higher interest rates, yields may react differently in this cycle given the extremely low interest rates and moderate economic growth (see Alpha Commentary - US Fed rate rate: Mixed impact on Asia, September 2015); and

c) Traditional commercial sectors are being buffeted by disruptions that will reduce the level of space required per worker/shopper/traveller (see Keppel Capital Watch – Real estate disruptions: Boon or bane?, April 2018).

With limited yield compression, the investment focus will thus have to be on alpha returns and alternative assets.

Alpha strategy

To achieve alpha returns above market expectations, this can be attained through "stock-picking" and/or active management. So even if yields were to rise, capital values can still increase if the pace of rental growth is faster.

Office sector

Among key APAC office markets, Singapore, Sydney and Melbourne have the highest rental growth prospects in 2018 but a new supply wave in the next few years will temper future growth. Seoul CBD rents are stabilising with improved economic outlook and abatement in pipeline supply; however the pace of rental recovery will be slow due to the existing vacancies. Other markets are seeing significant pipeline supply which is dampening rental growth.

However, rental growth can be found in pockets at the fringe CBD and some decentralised areas of Shanghai and Beijing due to better supply-demand dynamics even though the CBDs are facing rental pressure. Likewise there are opportunities in Hong Kong's CBD fringe, although the second CBD at Kowloon East is seeing much new supply while the CBD is facing MNC tenant resistance and a potential correction due to its very high rental rate. Tokyo's Grade B segment will do better with a large SME tenant pool compared to the Grade A segment which is seeing a wave of new supply.

Besides picking the right sub-markets and assets, more creative asset management and development concepts will also be required to give that alpha rental boost and return. In addition to the universal "location, location, location" criterion, experience and convenience for the end-user is becoming important in sieving the chaff from the wheat. Traditional single use buildings will find less relevance and appeal against buildings that accommodate multiple mixed uses.

Retail sector

The retail sector is facing several structural headwinds, foremost of which is e-commerce which still has much room to grow. Even fast fashion and F&B, which in the past few years have been the demand drivers, are facing challenges from the proliferation of online shops and food delivery platforms. Other structural challenges are declining or slow-growth population. Rising interest rates will also eat into disposable incomes especially in places with high household debts and low savings rates.

Average rental growth is subdued in most markets as retailers consolidate and go omnichannel. However, there are still investment gems that can buck the subdued rental trend, if one looks beyond the macro statistics: suburban community malls that target non-discretionary spending, large destination malls that provide a wide range of offerings for young and old, outlet malls that offer heavily discounted prices, and prime malls in key shopping

districts which cater to both tourists and locals. These can deliver steady income with higher yields than offices in the core/core-plus strategy, or provide the alpha/value-added rental returns through clever repositioning and mall management.

Emerging markets with less developed retail sectors and rising income/spending will suffer less than advanced countries like the USA which has high retail space per capita, many of which are in obsolete formats. China, despite having the highest e-commerce growth rate and high online sales penetration rate, still offers many retail investment opportunities with its strong growth in wages, consumption and domestic tourism. Growing population and rising consumerism is also supporting rents in prime malls in Ho Chi Minh City and Jakarta. In Singapore and Hong Kong, the retail sector has undergone pressure in the last few years but stabilisation is near with steady wage growth, low unemployment rate and returning tourists.

Alternatives

Traditional asset classes are being challenged by various structural changes and excesses. Retail space per capita requirement is falling. Retailer demand is less correlated with income and spending. The past correlation between employment gains and office demand is weakening gradually with automation, co-working and the trend towards more efficient and flexible layouts which would require less office space per person. There is also the risk of consolidation among the technology and co-working firms, both of which have been expanding quickly and were recent major drivers of office demand. Office space will be released when these firms merge, are bought over or fail.

Alternative asset classes such as data centre, senior living, healthcare, logistics, education, student housing, build-to-rent and infrastructure are thus looking increasingly attractive. They ride on long-term growth fundamentals of urbanisation, rising income and consumption, internet usage, e-commerce, ageing population and growing population (in emerging countries like Vietnam and Indonesia). Alternatives are also more recession proof and more resilient against geopolitical fallouts. The yields are also higher than those of traditional asset classes.

We expect these alternatives to become traditional asset classes in time to come as more institutional investors move into these spaces.

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