Southeast Asia Offices

Opportunities and Challenges

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Keppel Capital

watch

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Opportunities and challenges

Contents

Executive Summary

Southeast Asia (SEA) is a major economic power with one of the world's fastest growth rates. Currently the world's 6th largest economic region, it is expected to maintain strong economic growth of 5.7% p.a. between 2018-2022. We see five catalysts that will boost SEA's office sectors. These are:

- **Increasing trade integration** – free trade agreements, and other global/regional trade pacts over the next decade will boost businesses
- **Growth in digitalisation** – SEA is seeing a digital technology boom with more years of growth to come given the low base and young people who are tech savvy
- **Growth in sharing and gig economy** – the young population is driving record high funding and founding start-ups. The co-working sector is expected to constitute up to 15% of total occupied office stock by 2030, from less than 1% in 2015
- **Reform-minded regimes** – improving the business environment is an important factor in attracting investments and boosting the office sector. Vietnam, Indonesia and Thailand have made great strides in improving their ease of doing business rankings in the past two years
- **Transport infrastructure improvement** – many SEA countries have significant infrastructure programmes in the works, with the exception of Malaysia. Notably, Philippines and Indonesia are ramping up to develop their infrastructures after years of inactivity.

Investment in the SEA region is set to increase as investors seek higher returns. However, there are some challenges and mitigating actions to take note of when investing in SEA offices:

- **SEA is a diverse region** – local knowledge and experience is critical to navigate the wide range in investment environments
- **Rising US interest rates** – active management of leverage exposure and currency hedge is required
- **Proliferation and subsequent consolidation of co-working operators** – to lease to bigger operators with wider network as these are more likely to succeed
- **Delay or cancellation of infrastructure projects** – to see more concrete evidence of completion possibility before making investment decisions based on such infrastructure.

Author

Chua Chor Hoon
Director, Research

Introduction

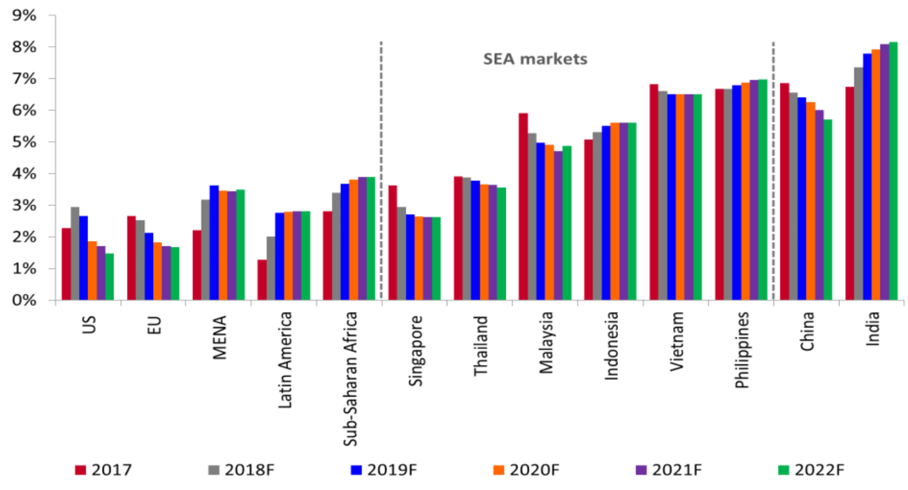
The Southeast Asia (SEA) region is a major economic power with one of the world's fastest growth rates. Currently the world's 6th largest economic region with a combined economic size exceeding USD2.6 billion in 2017, it is expected to maintain strong economic growth of 5.2-5.4% p.a. during the period 2018-2022[1]. This will be higher than other emerging regions ex China and India (see Fig 1). Fundamental drivers of the fast growth include:

1) **Strong demographics** – SEA has a large and young population. It is the 3rd largest market after China and India with over 650 million people. This is expected to increase to 726 million by 2030 with ~50% aged below 30[2]. This provides ample labour and consumption growth which attract foreign investment and drive demand for real estate.

2) **Urbanisation** – only half of SEA's population live in urban areas but this is rising rapidly. More than 90 million people in SEA are expected to move to urban areas by 2030[3]. The on-going urbanisation and shift of workers from agriculture to manufacturing and services will increase productivity and wealth.

While population growth and rising middle-income will drive the consumer and residential sectors, it is less clear what will drive the office sector in SEA with the exception of Singapore which is a financial hub. This paper aims to introduce the opportunities and challenges in investing in the SEA office sector, specifically in the six largest economies in the region i.e. Indonesia, Thailand, Philippines, Singapore, Malaysia and Vietnam, which make up over 95% of the region's GDP (see Table 1). Collectively they are known as ASEAN-6.

Figure 1: Projected GDP growth in SEA vs other regions (2018-2022)



Source: IMF World Economic Outlook (Apr 2018)

[1] IMF
[2] UN, World Population Prospects: The 2017 Revision
[3] UN, World Urbanisation Prospects: The 2018 Revision

Table 1: ASEAN-6 macro-economic indicators

	GDP size (USD bn)	Population (mn)	GDP per capita (USD)	Urbanisation rate (%)	Ease of doing business ranking
Indonesia	932	261	3,604	55	72
Thailand	407	69	5,899	53	26
Philippines	305	103	2,924	44	113
Singapore	297	5.6	52,961	100	2
Malaysia	296	31	9,360	76	24
Vietnam	203	93	2,173	35	68

Source: World Bank 2018

Office demand boosters

We see five catalysts that will boost the office sectors in ASEAN 6 key cities:

1) **Increasing trade integration** – SEA is already the world's fourth-largest exporting region, strategically located near China, India, and Japan. Trump's trade protectionist actions will spur other regions to trade more with one another. Successful implementation of the ASEAN Economic Community (AEC) integration plan, and agreements under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and Regional Comprehensive Economic Partnership (RCEP) will lead to more trade and investment flows into the region. As labour costs in China continue to rise and the trade war with the USA continues, SEA stands to benefit from a shift or set-up of alternative production bases outside of China which will further increase trade flows.

2) **Growth in digitalisation** – SEA is seeing a digital technology boom with the rapid development of telecommunications infrastructure and the spread of mobile phones. SEA is the third largest region in number of internet users and its population spends more time on the mobile internet than others in the world[4]. The large and growing digital population will sustain digital business growth and spawn new industries. The combination of young people who are tech savvy and highly connected is driving the start-up economy and infantile e-commerce industry. The technology sector is now a significant office demand driver.

3) **Growth in sharing and gig economy** – Co-working operators have also become one of the biggest sources of demand in many cities, including those in SEA. We see much room for growth in SEA given its young population which is driving record high funding and founding start-ups. The sector is expected to constitute up to 15% of total occupied office stock by 2030, from less than 1% in 2015[5]. The global trend of multinationals and large domestic corporates expanding into co-working space to enhance portfolio flexibility while fostering collaboration is expected to filter through to SEA markets in the coming years.

[4] Google and Temasek, e-Conomy Southeast Asia Spotlight 2017
[5] JLL Research

4) **Reforms** – a reform-minded regime in improving the business environment is an important factor in attracting investments and boosting the office sector, especially in emerging countries. Singapore has consistently been at or near the top in ease of doing business ranking, while Malaysia is within the top 25. Vietnam, Indonesia and Thailand have made great strides in improving their ease of doing business rankings in the past two years. In December 2017, Fitch upgraded Indonesia's credit rating to BBB on the back of economic stability and structural reforms. Thailand under the military leadership has risen to within the top 15% of countries globally in the ease of doing business in 2017. Philippines' ranking slipped last year to 113 from 99 the year before but this is expected to improve following a new law passed in May 2018 to improve the ease of doing business in the country.

5) **Transport infrastructure improvement** – recognising that poor transport infrastructure will limit economic growth, the ASEAN-6 governments have significant infrastructure programmes in the works, with the exception of Malaysia which recently rolled back some major projects due to fiscal issues. Singapore has one of the world's best infrastructures but is continuing to improve with more projects in the works. Infrastructure in Thailand is generally quite good with continuous improvement over the decades and the government is pushing for more projects under a Master Plan 2015-22. Vietnam is leading in infrastructure development in SEA under its government's reform and spending plans to achieve a high GDP growth of 6.5-7% p.a. Notably, Philippines and Indonesia are ramping up to develop their infrastructures after years of inactivity. Although not all the planned projects may go through or there will be delays due to land or funding issues and complex regulations, any improvement from the low base will be a boon. Infrastructure has a multiplier effect on the economy by improving productivity, attracting investments and creating more jobs and thence office demand.

Investment Opportunities

Singapore

It is one of the most business-friendly countries in the world with strong intellectual property rights protection and rule of law, talented workforce and forward-looking government. With increased regional integration and fast growth in SEA, its role as the gateway to the region will become more prominent as more businesses choose Singapore to locate their regional HQs and launchpads into SEA. Domestically the government's push for a smart nation is driving the growth of start-ups, fintech and other IT-related services. Co-working space is also expanding rapidly in line with global trend.

The Singapore office market is in an early up cycle with little new supply until 2023 save for a surge in 2021. Rents have been rising since bottoming in 2017 and cap rates have been compressed to sub-3% based on recent transactions and are expected to remain low with keen investment demand.

Thailand

Thailand has a thriving manufacturing sector with a well developed regional supply chain and a strong tourism industry which provide economic resilience despite political tensions. Its business environment has improved steadily over the last three years with stable leadership from the military government and growth in global trade.

Bangkok's office sector is enjoying steady demand and low vacancy rates. Co-working space and serviced offices is one of the fastest growing segment. With little new supply until 2021, rents are expected to continue to rise. The tightly held supply is a challenge to investors, but there could be opportunities to renovate and upgrade old office buildings.

Vietnam

It is expected to see one of the highest GDP growth with a stable political environment, strong reform momentum and favourable demographics. It is a prime investment destination in SEA especially for manufacturers given its proximity to China, long coastline and relatively lower labour cost. It is gradually becoming more open and investor-friendly, forging ahead with more free trade agreements and easing of foreign restrictions.

The office market in Ho Chi Minh City (HCMC) is into its fifth year of recovery. It is expecting its first mass rapid transit (MRT) line in 2020/21 which will boost development and investments near the stations. HCMC has the smallest office sector among the key cities in ASEAN 6 but is expected to grow with continued FDI inflows, fast economic expansion and extension of the CBD across the river to Thu Thiem. The office sector is not just catering to traditional office businesses, but also to co-working and serviced offices due to the young demographics. However, acute shortage of investable stock in HCMC means investors may have to consider development or upgrade older buildings as alternative options.

Indonesia

It is the biggest economy with the largest population in SEA and with abundant resources. However, GDP growth has decelerated to around 5% p.a. since 2014 with the end of the commodities boom. Nevertheless, Indonesia has progressed in deregulating its economy and improving business environment under the Jokowi administration which came into power in 2014. While foreign ownership restrictions have not changed much, the ease of doing business ranking has jumped significantly from 120 in 2014 to 72 in 2017. Jokowi's government has prioritised investments in 75 flagship projects including airports, roads, ports, railways and other key infrastructure. Jokowi is widely expected to win next year's election and continue reform in his second term.

The Jakarta office market is suffering from indigestion with abundant new supply since 2015, which far outweighed net absorption which had weakened in 2014-2017 as the profitability of oil & gas companies, one of the major office occupiers, declined with the fall in oil prices. Although demand improved in 2017 vs 2016, it was outweighed by new supply. Vacancy rate has risen to around 25% in 2Q2018[6]. While demand from traditional occupiers is subdued, pockets of activity are seen from the growing tech sector and co-working centres. These are driven by government support in incubating start-ups and digitalising the nation. A turnaround in the office market is likely in 2020 with supply moderation, acceleration in economic growth and business activity after next year's general elections, which will coincide with the operations of its first MRT line.

Malaysia

Malaysia is the second most developed and business friendly country in the region after Singapore and more affordable in terms of labour and occupancy cost. However, following the election upset in May, there are some uncertainties about the new administration's policies. Its decision to cancel or review several large infrastructure projects including the high speed rail to Singapore and Phase 3 of the MRT system in Kuala Lumpur (KL), while deemed necessary for fiscal prudence, reduces the potential for more real estate demand along the routes and in KL.

KL's office market is in an oversupply situation with substantial new supply in the past six years. Overall vacancy rate has risen to 20%[7]. Although rents are generally on a downtrend, there are some pockets of demand: 1) the completion of the MRT line last year has benefitted fringe and decentralised areas that it serves, 2) the slight recovery in oil prices has resulted in some pickup in leasing enquiries from the oil and gas industry which is a key demand driver, and from related industries, and 3) there are new office demand drivers, including Global Business Services (GBS), tech start-ups and co-working centres. With several more mega projects in the next few years, planning approvals of office buildings have been frozen and the current administration is reviewing all mega projects, which will help the office market to recover faster. Given the relative affordability of KL offices, there are some opportunities to invest in areas where the demand/supply situation is better, although the general market will take longer to recover as overall new supply will continue to outweigh net absorption.

Philippines

It is riding a 6-year boom with GDP growth in the band of 6-7% p.a., having the youngest and fastest growing population in SEA, and a high level of overseas remittances (~10% of GDP) providing a solid consumption base. In the Philippines where infrastructure is most inadequate among ASEAN 6, the current Duterte administration has ambitious plans for 222 national strategic projects of which 127 are under construction and over 20 completed. The completion of some, if not all, of these projects will be a boon to the economy and real estate sector.

Office vacancy rates in Metro Manila are currently tight at sub-5%, as the English-educated population and attractive tax perks have attracted many business process outsourcing (BPO) and knowledge process outsourcing (KPO) companies which are the key sources of office demand in the country.

[6] C&W, Jakarta CBD Office Marketbeat June 2018

[7] Edmund Tie & Company/Nawawi Tie Leung, Malaysia Real Estate Market Times Q2 2018

Lately offshore gaming firms servicing clients mainly in China have become major contributors of office demand as the relationship between China and Philippines warmed. Online shopping platforms and co-working operators have also taken on space though still constituting a small percentage. Despite a healthy pipeline of supply over the next few years, rents are expected to continue to rise given the tight vacancy and strong economic growth which will be boosted by the new infrastructure developments. The key risk for the office sector will be slower growth from the BPO and KPO companies due to 1) the Trump administration targeting outsourcing of jobs by US firms, or 2) the Duterte administration's proposal to reduce tax perks which may affect Philippines' competitiveness as an outsourcing hub.

Challenges

Investment in the SEA region is set to increase as investors seek higher returns. With China slowing down, trade war with the US, and the Belt and Road initiative, more Chinese investors are looking at investments in SEA, joining other Asian investors such as the Japanese and Koreans. However, there are some challenges to take note of when investing in SEA:

1) SEA is a diverse region with different stages of maturity, economic structures, regulatory regimes and cultures among others. Local knowledge and experience is critical to navigate the wide range of investment environments.

2) Rising interest rates in the US has triggered substantial capital outflows and currency depreciation, and also resulted in the SEA central banks raising their policy rates. Active management of leverage exposure and currency hedge in these markets will thus be required.

3) The proliferation of big and small, local and international co-working operators means there will be some consolidation in future. Instead of fretting over the long-term sustainability of co-working operators and rejecting such tenants, a more forward-looking strategy would be to lease to big international operators as these are more likely to succeed with economies of scale, bigger presence, deeper pockets and ability to differentiate with unique proposition.

4) Some of the infrastructure projects, especially those in the cities which will have more direct impact on real estate values, may not materialise. It is advisable to see more concrete evidence of completion possibility before making investment decisions based on such infrastructure.

Conclusion

SEA is a fast growing region not to be ignored. Demand for offices is expected to rise with increasing trade integration, growth in digital and sharing economies, and importantly reforms and infrastructure programs being carried out which will enhance the ease of doing business and attract more investments. Investment risks are however higher compared with developed economies; hence prudent mitigating measures and good local knowledge are required.

Keppel Capital is a premier asset manager in Asia. It is the asset management arm of Keppel Corporation Limited, a multinational conglomerate with key businesses in Offshore & Marine, Property, Infrastructure and Investments, providing innovative solutions for sustainable urbanisation.

With assets under management of approximately S$29 billion, Keppel Capital has a diversified portfolio that includes real estate, infrastructure and data centre properties in key global markets.

Keppel Capital aims to create value and deliver sustainable returns for institutional and retail investors through a range of products including REITs, business trusts, private funds investing in real estate and infrastructure, separate accounts and pooled investment vehicles.

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