savills investment management

GLOBAL REAL ESTATE INVESTMENT

Outlook 2023

THROUGH THE HEADWINDS: WHERE TO FIND VALUE IN 2023 AND BEYOND

Contents

VISIT THE WEBSITE

savillsim.com/digital/outlook-2023

Introduction from the CEO

Alex Jeffrey

Chief Executive
Savills Investment Management

As the past year has shown, even the best-laid plans can go awry. We entered 2022 feeling relatively optimistic, but global economic and geo-political developments have changed the macro environment.

In many real estate markets, risk-off sentiments have intensified, putting pressure on capital values and occupier performance. That said, we believe in our time-tested approach of sticking to solid fundamentals and adapting our strategies accordingly.

In this year's Outlook report, Hamish Smith assesses the repricing that is already happening in some markets. In such an environment, the focus must be on quality assets underpinned by strong fundamentals, ESG credentials, and the ability to generate rental growth.

There are several common threads throughout the report. Notably, we see very clear and practical demands from occupiers for better quality real estate. Occupiers quite evidently want more energy efficient and operationally suitable buildings. This will widen the performance gap between prime and non-prime, and will support values and growth in the former, but punish investors unable to maintain quality. ESG is a practical consideration that investors must embed in their decision making.

Andrew Allen and Matteo Vaglio Gralin note that there has always been a considerable range in returns within sectors, and that these ranges are growing. This implies a keen focus on the differences across and within markets. They suggest that investors should be wary of 'throwing the baby out with the bathwater'. In other words, rewarding opportunities exist even within unloved sectors. Christian Mueller highlights how resilient urban Industrial and Logistics assets have been during the pandemic and how this is set to continue. Indeed, the occupier pressure upon modern, efficient and flexible urban space is likely to surprise on the upside.

In the Living sector, Adam Alari examines the strong fundamentals alongside the rise in need and opportunity in affordable housing investment, together with a compelling investigation into rental regulation.

In the Office sector, Hamish Smith and Matteo Vaglio Gralin explore the risk of polarisation in this market. Whilst offices will remain the main place of work for such business service functions, the requirement from occupiers for greater flexibility will reduce demand, albeit into much better space. Assets unable to maintain relevance will see values drop sharply and will likely need to be put to alternative uses. Taking a regional perspective, Shaowei Toh explains his conviction that APAC offers excellent diversification in this economic cycle.

Our debt team is well placed to step in where banks take an overly cautious view, leaving opportunities for alternative lenders, as Mohamed Ali explains.

And finally, as stakeholders and leaders drive greater action on climate change, Dale Lattanzio Jr explores the rise of the voluntary carbon market and how investors can derive economic value by doing good.

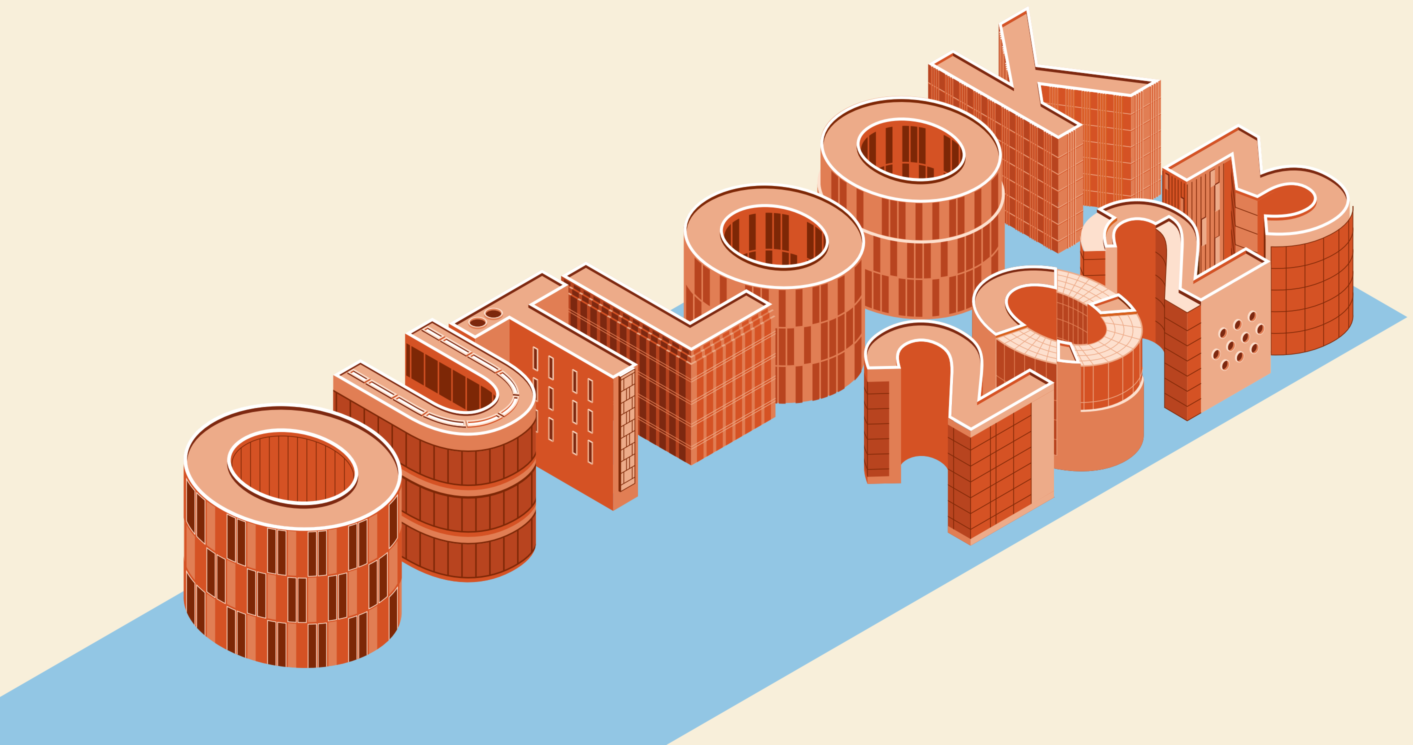
In this edition of our annual outlook, we hope to provide our responses to your pressing questions as we march into the first months of 2023.

We have compiled our views from both a top down and a bottom-up perspective, utilising our localised resources of 16 offices, staffed with over 350 professionals.

We hope you enjoy it.

What are the big questions in real estate in 2023?

As investors look to the coming year, some concerns loom large. We surveyed our associates and capital partners on the issues that keep them up at night – we hope to provide some clarity as to our view, and the work we are doing to ensure our investment strategies are on course.



1 How should investors be positioned in a risk-off environment?

A repricing of some real estate assets has already started in some markets as the world faces up to rising interest rates, economic recession risks, historically high inflation and runaway energy prices, all of which pose their own challenges for various real estate sectors. As the repricing continues, lenders and investors will become more risk averse, leading to lower transaction volumes. In addition, investors and occupiers demanding more robust ESG credentials are increasing the risk of obsolescence.

In such an environment, it is vital to focus on quality assets with strong supply and demand fundamentals and ESG credentials, that have the ability to generate rental growth. Failure to maintain focus on essential qualities could easily result in exposure to stranded assets with difficulties in refinancing. The gap in pricing between good and bad will emerge as a common theme in 2023 and beyond.

We have seen how resilient urban Industrial and Logistics assets have been during the pandemic and we believe this will continue, as competition for land intensifies in urban centres around Europe. APAC offers excellent diversification for investors seeking shelter from some of the recessionary forces at play in the West, with relatively low inflation and resilient tenant performance across all sectors, especially multifamily assets in the region.

Essential retail has demonstrated its resilience throughout the pandemic and will continue to do so as the squeeze on household incomes from rising rates and inflation will likely lead to a cutback in discretionary spending. This points to assets such as convenience retailing (parks or standalone) continuing to provide a relatively safe haven. Crucially, these retailers often have long, index-linked leases that are particularly attractive in the current environment.

2 Is Living still the sector that keeps giving?

Getting on the housing ownership ladder remains an unattainable dream for many young people, as rising prices and now, interest rates, put property out of reach of many buyers. This is driving further demand for affordable rented accommodation which is already suffering critical shortfalls. There are appealing opportunities in both the subsidised and middle-income affordable rental sectors, both of which can provide predictable and resilient income streams. In terms of meeting ESG requirements, affordable housing has arguably the greatest social impact, and opportunities exist to extract greater premiums with the addition of carbon-reduction measures.

But opportunities within Living are not just about family homes - purpose-built student accommodation and senior housing are also sectors with strong fundamentals, supported by demographics and social trends, that offer the ability to diversify. Meanwhile, multifamily investments around the world have proven to be among the most resilient assets throughout numerous economic cycles. We see allocators increasing their intentions to invest in this sector for the long, durable income stream that it produces.

3 How can investors better unbox the opportunities in the logistics sector?

Investors have been well rewarded for their exposure to logistics in recent years, but we suggest that some do not appreciate the depth of the wider industrial market, where fundamentals are just as compelling. Consumers' increasing demand for speed and convenience means urban logistics sites, and those close to urban centres with good transport links, will remain more attractive from a future rental growth perspective than "big box" assets in more remote locations.

There are also exciting opportunities to upgrade ageing industrial stock, installing facilities to attract staff and improve energy efficiency, and ensure they meet the very latest and upcoming ESG requirements.

This is one of the sectors that we believe ticks all boxes from strong fundamentals, modern ESG credentials and the ability to generate strong rental growth, which we think will be most rewarding for investors. Even so, there is a chance that these assets, particularly those in need of renovation, suffer price falls along with other sectors in a broad-brush repricing. That could present an attractive entry point, although each site needs careful assessment on its merits.

4 Can real estate debt lend itself to attractive risk-adjusted returns?

The short answer is yes, but there are caveats. With the likely repricing of real estate and broadly uncertain economic environment, many lenders are taking a more risk-averse view. But this provides opportunities for alternative lenders who can identify resilient lending opportunities and provide funding on more flexible terms than many mainstream banks.

On the borrower side, around 45% of all UK commercial real estate debt in the UK is in need of refinancing in the next two years, rising to 75% by 2026 . Given the dramatically increased cost of debt, some well capitalised borrowers will opt to refinance by contributing fresh equity, while many others will be requiring debt from the market to fill the gap. Nevertheless, liquidity in the market will be tight as caution dominates sentiment. Borrower demand, on the other hand, is likely to be high due to the volume of transactions needing to refinance. Carefully selected investments in resilient sectors could therefore lead to attractive risk-adjusted returns.

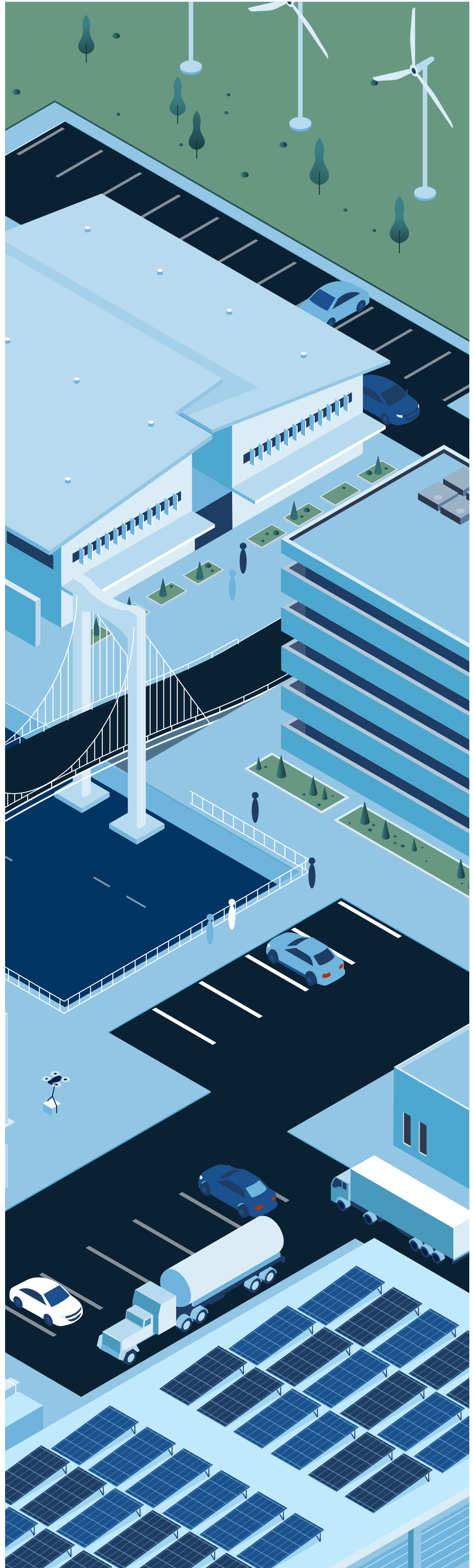
5 Is Asia Pacific well positioned in this cycle?

We are positive on the Asia Pacific region in general, and it is particularly well-placed to provide diversification for investors with exposure to Western markets. Primarily this is because the region is at a different stage in the cycle compared to most of the rest of the world. Inflation is muted, thanks largely to better management of the pandemic; lockdowns were less common and less severe in many markets, resulting in less of a demand shock.

Central banks in the region are not likely to need to raise rates as aggressively as in the US, UK or Europe. Unemployment remained low during the pandemic, while vaccination rates in many countries are now above the global average, which bodes well for reopening.

Without high inflation and overly tight monetary policy, the region is well positioned, but it is not without its challenges. Repricing on fixed income will undoubtedly feed through to valuations at some point but nobody knows when or to what extent. We are under no illusion that the global macroeconomic challenges will filter through more prominently in the region at some stage, so there are definitely risks in the outlook.

This will likely make lenders more risk averse, which poses potential problems for those in need of finance or to refinance existing debt. In addition, as rates increase, income will become more important and the capital growth that has contributed so much to returns in the region over recent years will become much harder to come by. Overall, however, a resilient occupier market and good occupier performance across numerous sectors should provide plenty of opportunities on a selective basis, with expert asset managers on the ground an essential prerequisite.



6 Why ESG is more relevant now than ever?

A material difference in this economic cycle is that the real estate industry is commonly starved of high quality modern, energy efficient and ESG compliant buildings. The sector is now taking ownership of the fact it is responsible for 40% of all greenhouse gas emissions globally. This is filtering through to every market participant and stakeholder, from financiers to developers, investors to tenants.

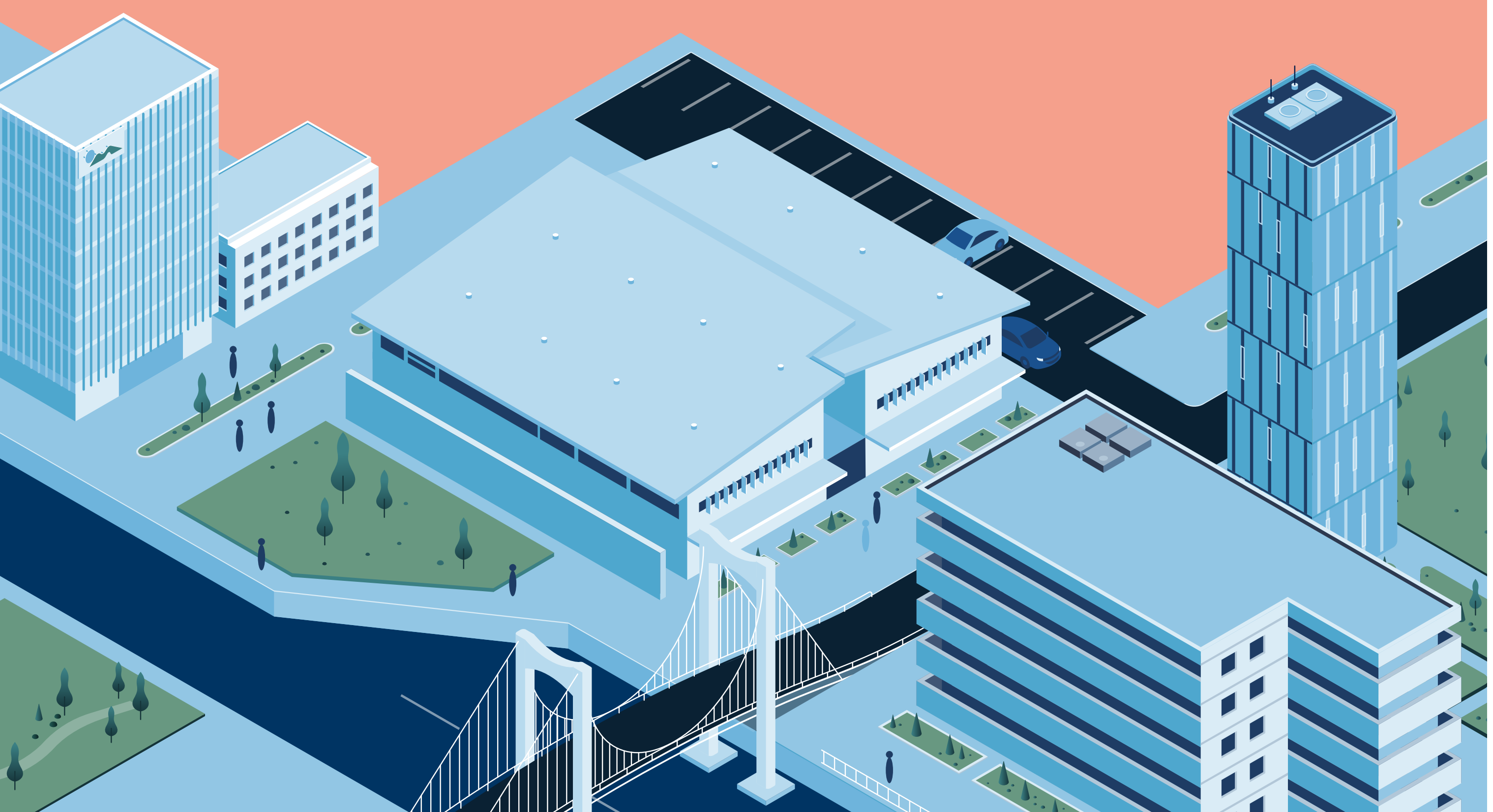
The push for net zero means that buildings that do not have adequate ESG credentials are suffering from a “brown discount”, which raises the risks of stranded assets for those that do not have other redeeming qualities such as high-demand locations. In some cases this is also an opportunity, since it provides scope for retrofitting, upcycling, and consequent capital growth and rentability for suitably located assets.

A plethora of new regulatory requirements is also forcing change. For the investment industry, the Sustainable Finance Disclosure Regulations (SFDR), introduced by the EU, have global ramifications, and are forcing investment managers to adequately explain, quantify and demonstrate that they meet strict criteria to ESG standards and transparency. Proving adherence to SFDR is an ongoing challenge that, if anything, is becoming more difficult as tests become more granular. But it is essential that they are met. The US, UK and APAC may pursue different ESG solutions but investors and asset managers in these regions can still be impacted by SFDR if they have investors or managers located in the EU.

Finally, there is an increasing focus now on the “S” in ESG, as investors want to demonstrate social impact through initiatives such as affordable housing, and on new dimensions of the “E” in ESG, positive outcomes for nature, such as increasing biodiversity, regenerative farming and other restorative approaches that are coming into focus. In short, every real estate investor needs to consider ESG as part of every investment, or risk having to revisit it later or, worse, sell an obsolete asset at an increasingly punishing discount.

The devil is in the detail, not least in retail

There is good and bad in every sector, right across the real-estate spectrum. We take a close look at the huge disparity in returns in retail real estate to demonstrate why expert knowledge and asset-picking abilities are key - not just in retail but across the board.



Andrew Allen

Global Head of Research, Product Strategy and Development

Matteo Vaglio Gralin

Senior Analyst, Southern Europe, France

Real-estate investors typically seek to allocate around sector or regional fundamentals. Indeed, there is a tidy logic to assuming the benefit of a clear, dedicated sector or regional allocation. This might be to say German offices or European logistics or Japanese multifamily, and investors have access to many funds and services that provide exposure to such markets and sectors using this broad-brush approach.

However, there is strong evidence that suggests investors should be more detailed in their understanding about these specific strategies especially given the financial environment we expect in the coming months and years.

One country and sector that illustrates this point particularly well is UK retail. We will use this sector as an illustration but the same logic around range of returns applies across all sectors and geographies.

Fundamentally, the global retail market has shifted. The growth of e-commerce and the diversion of sales to non-physical formats has damaged store-based sales and the respective retailer margins achieved via their physical property formats, thus impacting the rents they can pay and, consequently, investment values. That strongly implies that investors would have done well to shun the retail sector in recent years - and would do well to avoid it going forwards.

Indeed, the UK retail sector, as a whole, has underperformed the 'all property' sector in each year of the last decade, according to MSCI data.

However, when we dig a little deeper, the detail becomes much more interesting. Quite obviously, not all retail is the same and there is a world of difference between retail segments – department stores, shopping centres, high-street shops, retail warehouses, supermarkets, outlet malls and so on; the headline macro drivers are the same, but the underlying fundamentals are understandably different and so too the returns.

The range of annual returns across the MSCI UK retail segments has been substantial and has widened over the last decade. In 2012, there was just a 5.2% range in total returns between retail segments (supermarkets performing best and retail warehouses worst) but this gap has expanded greatly. In 2020, the range was 34.2% (supermarkets best and shopping centres worst), in 2021, the range was 28.5% (retail warehouses best and shopping centres worst).

Importantly, the performance of the best retail segments has nearly always comfortably outperformed the "all property" sector average over the last 10 years.

For example, the UK supermarket sector displayed great resilience of income streams during the pandemic and provides excellent dividends. Moreover, food is generally less exposed to changes in discretionary spending due to economic downturns. This is why the sector has climbed in investor preferences and has been a significant outperformer.

Taking the specific example of the UK retail warehouse market, we can see the importance of understanding segment and asset-specific factors even further. The annual difference between the 10th percentile and 90th percentile retail warehouse assets has been over 10% total return in every year of the last decade. Interestingly this range has widened considerably to over 20% range in the last 4 years (2018-2021).

As with the supermarket illustration, we have witnessed distinctly stronger performance from retail warehouses linked to necessity, value and convenience for their shoppers, against those more akin to a town-centre retail offer.

Retail has always been about the detail, and we believe the same is true of all real-estate sectors.

At Savills Investment Management, we fundamentally believe in the importance of a 'top down' contextual macro and capital-markets framework, but we also firmly believe our investors should be served by specific understanding of the wide variation within our markets.

- Macro fundamentals are just our starting point, thematics really matter too.
- Be wary of 'sector myopia' as the range of returns within, rather than across, sectors over time provides much more variation. Focusing on the best segments within any broader property sector has the potential to produce much greater risk-adjusted returns to investors.
- For those sectors in and out of favour, the market can show blindness. This means not indiscriminately pursuing sectors in vogue, or entirely dismissing other sectors that appear to be underperforming.

We expect variations to be especially high in the coming year, and in the following articles, our specialist analysts will be explaining the nuances and opportunities that they see in the specific sectors they cover.

The big picture: no avoiding the pain in 2023, but opportunities will present themselves in Europe

"The current environment is likely to present some mispricing opportunities for assets that have strong long-term characteristics, including ESG credentials and the ability to generate income growth."

Hamish Smith
Head of Research & Strategy, United Kingdom

Matteo Vaglio Gralin
Senior Analyst, Southern Europe, France

With the re-pricing of various asset classes in 2022 it was inevitable that real estate would follow suit. This is not going to be easy for existing investors, but sectors with strong underlying fundamentals are better placed to weather the near-term storm. Of course, times of high market stress can also provide opportunities, although entry prices need to be carefully assessed. In addition, investors need to consider current and potential ESG credentials, together with future rental growth feasibility.

Near-term challenges will keep many on the sidelines

A number macro and public market signals indicate that the environment for real estate in 2023 will remain challenging, particularly in H1. The near-term macro picture is gloomy, with high inflation, rising interest rates and recessionary risks impacting investment and occupier markets. Higher interest rates have eroded real estate's risk premium over fixed income, and this has resulted in a broad-brush re-pricing of the sector.

Key market signals	Outlook for 2023	Comment
Economy	Negative	Expect lower liquidity & capital flows in 2023 as investors sit on the sidelines due to higher debt costs, re-pricing and economic uncertainty. Denominator effect also acting as a constraint to allocating to real estate. Correction in property values to continue into 2023 with a potential floor mid-year. This could create an entry point for investors for core and value-add assets with good long-term fundamentals - including strong ESG credentials. Assets with high capex requirements are potentially at higher risk of obsolescence.
Capital Flows	Negative	
Property Yield Shifts	Negative	
Spread Property Prime vs Secondary	Neutral	
Property Spread Over 10y Govt Bonds	Neutral	
Real Estate Debt (lending margins)	Neutral	
Listed Markets (discount to NAV)	Positive	

Source: Savills IM Research & Strategy

In the 10 months to the end of November 2022, prime office yields increased by 65 bps in Paris and 25 bps in London, and further outward shifts are anticipated across Europe. Today's market conditions are not the same as during the GFC. Back then, prime office yields expanded by 240 bps in Paris and 200 bps in London. Whilst it remains to be seen how far yields will move out in this cycle, given the much lower initial starting point, yield expansion will have a proportionally greater impact on values this time round.

The European listed sector[1], which tends to set the direction of travel for the direct market, had fallen by close to 40% by the end of November, similar to the decline at the start of the Covid-19 pandemic. That is not to say that we expect direct real estate values to fall by the same amount. But it suggests some sizeable valuation cuts are likely.

[1] FTSE EPRA NAREIT developed market price return index

Payment shock awaits those refinancing

Investors with high levels of debt and those needing to refinance will feel the greatest pain from higher interest rates. In the UK, around £75bn of outstanding loans will need to be refinanced over the next two years[2]. This could result in various points of market stress as much of this debt is refinanced at higher interest rates. Falling valuations mean that higher LTVs could act as a constraint on the cost and availability of funding.

Occupier markets are facing turbulence too, as slowing growth and the increasing likelihood of a recession, raise the prospect of more tenant defaults. In addition, as firms deal with higher costs and lower revenues, some will put expansion plans on hold, exacerbating existing void periods and income growth.

Although it might seem incongruous to speak about a recovery when we are yet to reach the nadir of the current downturn, as economies begin to recover (at some point in 2023) so too will real estate. We shouldn't rule out further downside risks, including a more prolonged recession. But unlike previous property cycles, this one hasn't been characterised by oversupply, and occupier markets generally remain tight.

Thus, even if vacancy rates do rise, it seems unlikely that there will be a long period of excess supply, at least for high-quality prime buildings, as sharply higher construction costs and interest rates constrain near-term development, supporting future rental growth in supply-constrained markets.

Nobody wants to catch a falling knife. But the current environment is likely to present some mis-pricing opportunities for assets that have strong long-term characteristics, including ESG credentials, and the ability to generate income growth. This would allow investors to be well-positioned for when the next upturn arrives.

Sector Statistics

40%

The fall in the value of the European Listed property sector since the start of 2022

£75bn

The value of outstanding loans that need to be refinanced over the next two years

65bps

The increase in prime office yields in Paris since the beginning of 2022

[2] Savills IM calculation based on Bayes CRE Lending Report MY 2022

Europe's 'Living'* sector is coming of age, and will come out of this cycle strongly

Jon Crossfield

Head of Strategic Partnerships and Living

Adam Alari

Head of Living Research & Strategy, Europe

"The current housing shortages show few signs of being addressed satisfactorily. Indeed construction levels are more likely to fall."

The Living sector has provided stable yields and substantial capital growth for much of the past decade, fuelled by low interest rates, extreme demand/supply imbalances and increased private and institutional investment. As a result, European net initial yields have fallen sharply. But rising inflation and interest rates have brought this cycle to an abrupt end.

The gap between buyers' offers and vendors' asking prices is increasing, as buyers push for discounts to reflect the rising cost of their capital. The short-term outlook is therefore uncertain - capital values are falling and, as sentiment deteriorates, finance will remain scarce. An over-reaction by lenders to tighten criteria further could exclude many buyers from the market and exacerbate downwards re-pricing.

Multifamily is primarily a proposition for those in search of a stable yield, which has historically been the case (see yield chart below), but capital values in the multifamily space will inevitably be brought down, to some degree, by any widespread correction in the broader market. Looking at the spreads in the chart below, while we believe residential spreads will rise further, we do not believe they will widen to same extent as the logistics space, and are likely to be more resilient than the technologically-challenged office and retail sectors.

Predictable returns: multifamily yields hold steady

Source: CBRE Monthly Yield Shield, data of Oct 2022. Presenting levels from 2012 and 2022 , note: spreads calculated using simple European averages on prime net initial yields

So, why do we believe the prospects for the Living sector are so strong?

Difficult as the short-term environment will be for existing investors, it will provide a more attractive entry point for new investors, or those with a robust enough constitution to invest further, expanding their portfolios at lower prices and consequently higher yields. Equity buyers will also be at a substantial advantage as credit available for institutions may well also tighten until the outlook becomes more certain.

Nobody can predict when the market will bottom, but we remain bullish over the medium and certainly, longer-term view, and will regard a correction as an opportunity to deploy capital on a selective basis, targeting assets that have perhaps been over-priced in the recent cycle.

Importantly, the Living sector's appealing fundamentals that we have highlighted in earlier Outlooks remain intact. In fact, they are arguably strengthening and, relatively, they are typically stronger than most commercial markets. Living assets produce higher risk-adjusted returns and are thus compelling for portfolio diversification.

Indeed, we also recognise that the depth of investor activity and experience in Living varies widely across countries and segments; some markets highly developed domestically (Germany, Netherlands, UK PBSA*) and some more nascent (UK Multifamily, Spain, Italy) but few investors have diversified across the region as is common in commercial real estate.

This all means that the tension for growth of Europe's rents is of course, high. That's potentially great for investors, but we must consider the impact on our communities.

THE FUNDAMENTALS FOR THE LIVING SECTOR

- Putting a roof over one's head is a necessity, this is not going to be dislocated by technological advances that adjust the way we buy goods, work in offices and so on, and the need for housing won't adjust simply because the economies weaken. Yes, affordability might be challenged, but the need will not be.
- The current housing shortages show few signs of being addressed satisfactorily. Indeed construction levels are more likely to fall in the short term.
- We increasingly recognise that the quality of Europe's housing stock is inadequate. It is typically quite old, not energy efficient, of the wrong size, and all of this is most acute in the cities where people most want to live.
- Demographic changes such as longer life spans and later family formation also exaggerate the need for smaller housing units, and this stretches the imbalances further.
- At the same, time prospective owner occupiers are constrained by their access to, and cost of, finance.

Quite obviously, affordability will be key and there is a clear risk to address, that being the rise and implications of various rent regulations which we discuss in a further article in this Outlook.

We can only conclude that while the sector fundamentals are extremely robust, from a tactical point of view, the sector that is most compelling is affordable housing. With that in mind, the near-term pricing adjustment appears to be a timely opportunity to build up exposure.

**At Savills IM we prefer to use a wide sector classification of Living, rather than residential, to encompass a range of investment segments that includes single and multifamily housing, purpose-built student accommodation, senior and care associated facilities alongside affordable housing and micro and co-living etc. We will be elaborating further on our assessments of market scale, dynamics, operational intensity, risks and pricing over the course of 2023.*

Affordable housing, for long-term impact and growth

Adam Alari

Head of Living Research
& Strategy, Europe

Andrew Allen

Global Head of Research,
Product Strategy and Development

"The public purse typically appears unable to fund the delivery of public housing. In our view, the public sector has no choice but to engage the private sector, and we think the pressures for this intervention are increasing."

Definitions help investors assess the prospects and risks of real estate on a consistent basis, none more so than with regard to Living real estate. As highlighted elsewhere in our Outlook 2023, we are sure that 'affordability' is key to successful Living investment strategies and must be a focus for responsible long-term investors.

So, what do we mean by 'affordability' and how should investors factor such considerations into their strategies?

A dictionary definition of affordable is probably the best starting point, which describes affordable as "inexpensive or reasonably priced". Applied to the housing market, it implies a focus on mid-market rental housing priced for the mainstream workforce population.

When we assess affordable housing for our investment strategies, we look at both this type of mid-market affordable housing, and social housing, typically let at discounts to market rents and subject to government regulations.

Affordability concerns are growing across the socio-economic spectrum

The rising cost of living has brought housing affordability firmly to the fore in Europe. House-price escalation, since the global financial crisis, has delayed ownership for some generations and put it out of reach entirely for many others, putting further pressure on the rental stock and its price.

Specific measurement of affordability is complex, but the facts are stark. Of the c.220 million EU households, approximately 82 million people spend more than 40% of their disposable income on housing[3].

A common rule of thumb being that affordability is breached when residents are paying more than a third of their disposable income on housing.

[3] European Comission, "The Future of Cities - Affordable Housing" (12th December 2022), https://urban.jrc.ec.europa.eu/thefutureofcities/affordable-housing#the-chapter

As costs rise, then more people are placed under financial stress, and this produces a wider pool of potential renters versus owners. We see that renters have higher earnings, that they are older and that they rent for longer. Strategically, affordable housing should be a key target.

Indeed, there are significant advantages of appreciating this dynamic for the operational management of affordable residential - keep the residents happy, they stay longer, that improves community and impact effects (health, educational attainment, reduced crime levels etc) and indeed the Net Operating Income too. That's a "Win Win Win" situation for residents, investors and policymakers. We will be extending the depth of our work in this regard through 2023 and welcome the opportunity to share this with our clients.

Homing in on social housing

There is a more technical aspect to affordable housing, that of the subsidised social-housing market. Social housing has traditionally been funded by the public sector. But there is now an urgent need for private capital to supplement public-sector spending, and help resolve the shortfall in affordable-housing supply across Europe.

From France to Sweden, the demand for subsidised and low-cost housing has never been greater, yet no single state appears able to supply it in a way that delivers a structural solution. We see the same issue across our markets, and we are sure that our readers will recognise the shortfalls of affordable housing in their markets, such as the long waiting lists and the challenges of delivering supply at scale.

In some economies, the private sector has created investable models (France and The Netherlands) but in others the development to date is limited (UK). There are reasons to believe this is changing and that it will change swiftly. Not least that the public purse typically appears unable to fund the delivery of fully public housing. This issue is exaggerated by the scale of the finance needed to repair and improve social housing, such as for its insulation and energy efficiency requirements. In our view, the public sector has no choice but to engage the private sector, and we think the pressures for this intervention are increasing.

- We reflect the UN Sustainable Development Goal 11 'Make cities and human settlements inclusive, safe, resilient and sustainable', for which the Target 11.1 is 'By 2030, ensure access for all to adequate, safe and affordable housing and basic services and upgrade slums'.
- With the drive to achieve net zero carbon, there is also a great deal of pressure to provide affordable housing that meets the highest standards when it comes to energy efficiency and carbon reduction.

Affordable housing is clearly needed at huge scale and must be delivered through new construction and improvement of existing buildings to meet ever-increasing demand and higher build standards. We firmly believe that responsible long-term investors should make this part of their investment focus in 2023 and beyond. Their impact could be huge. We explore the political and regulatory risks in a further article in this Outlook.

Residential rent regulation is not a barrier to attractive and predictable returns

Adam Alari

Head of Living Research
& Strategy, Europe

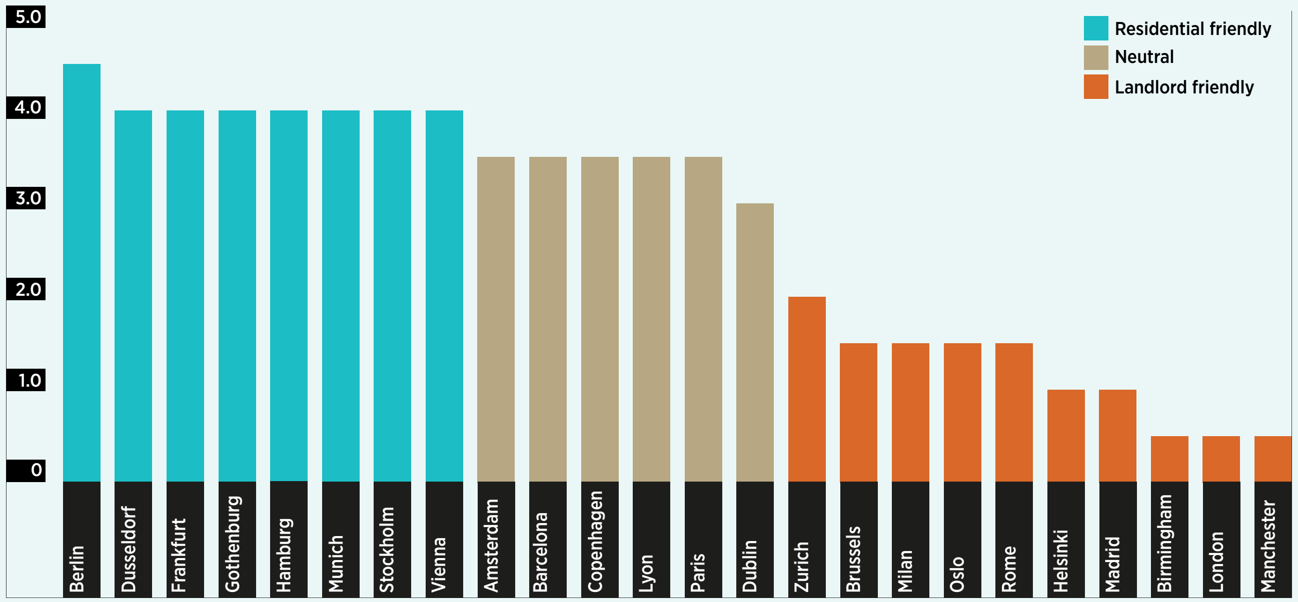
"Balanced regulation, including rental caps, can support predictable income returns and prevent units from becoming too expensive for the residents."

Most economists agree that rent regulation is a negative for the efficient operation of housing markets and fails to address the elephant in the room - supply.

To be clear, when talking about regulations, both resident protections and rent controls, they need to be considered together, as these are both important aspects of a fair and efficient housing market. As we have covered in other articles for our Outlook 2023, we see the fundamental shortages of European housing pushing rents higher, and the debate around forms of rent regulation can only intensify. To us, it is an imperative that investors are part of the debate around fair regulation, recognizing the important role that they have in providing long-term homes for those that cannot own for themselves, or choose not to.

In terms of what rental caps mean for investor income, very little academic analysis has been carried out on this topic in Europe, while there has been some work in the US on the impact of resident protections on net operating income. In short, the impact depends on the nature of the regulation or control, and it is wholly incorrect to assume this is a binary position. There are many shades of control, and whilst regulation can be bad, it might also be acceptable too.

Residential regulation rating



Source: Savills IM, DLA Piper, national governments, data as at October 2022

Yet regulation is an ever-present feature of the European residential landscape, and it will be difficult to avoid in some form or other.

As a socially responsible investor, mindful of the UN's Sustainability Development Goals around decent homes, Savills IM believes that balanced regulation can be a positive for the fundamentals of the asset class (stable and secure income) as well as communities (stable, long-term homes). Indeed, regulation is something investors should recognise, learn to accommodate in the underwriting, and seek to monitor closely.

We readily accept that regulation can be bad, and has often been materially unhelpful. As the recent DW und Co. Enteigen referendum and subsequent law MietenWoG Bln (subsequently reversed by Germany's national Constitutional Court) highlighted, regulations that are both surprising and that disproportionately disadvantage landlords, act as a brake on development and investment.

But this simply implies that the industry needs to adopt as collaborative an approach as possible with policymakers. We recognise the highly political atmosphere, and therefore risk, in some residential markets. But, equally, we recognise that policymakers are wary of scaring the capital sources that our cities so badly need to solve the huge housing crisis we face.

There are many examples of balanced regulatory systems around Europe, within which investment has remained strong. Indeed, controlled rents are a common feature of many forms of investment, which are liked because of their certainty. It is not the regulation that actually concerns investors, it is its form and stability. In addition, the performance of Europe's regulated residential investment markets has been at least as good as those that are not regulated – this is an area that we are continuing to research and monitor.

While it is causally unclear if and to what extent regulations reduce capital-value volatility, it seems reasonable to assume rental caps, as well as the granularity of residential leases, contribute to the stability of risk-adjusted returns relative to the commercial real estate sectors. Consequently, further regulatory changes should be expected across Europe, arguably with more powers devolved to city municipalities, as housing pressures remain such a hot political issue.

Our view is that balanced and stable regulation can be a positive for long-term investors. Balanced regulation, including rental caps, can support predictable income returns and prevent units from becoming too expensive for the residents. This likely means residents stay for longer, pay their rent with low risk of void or rent arrears, and consequently enhance Net Operating income and its predictability.

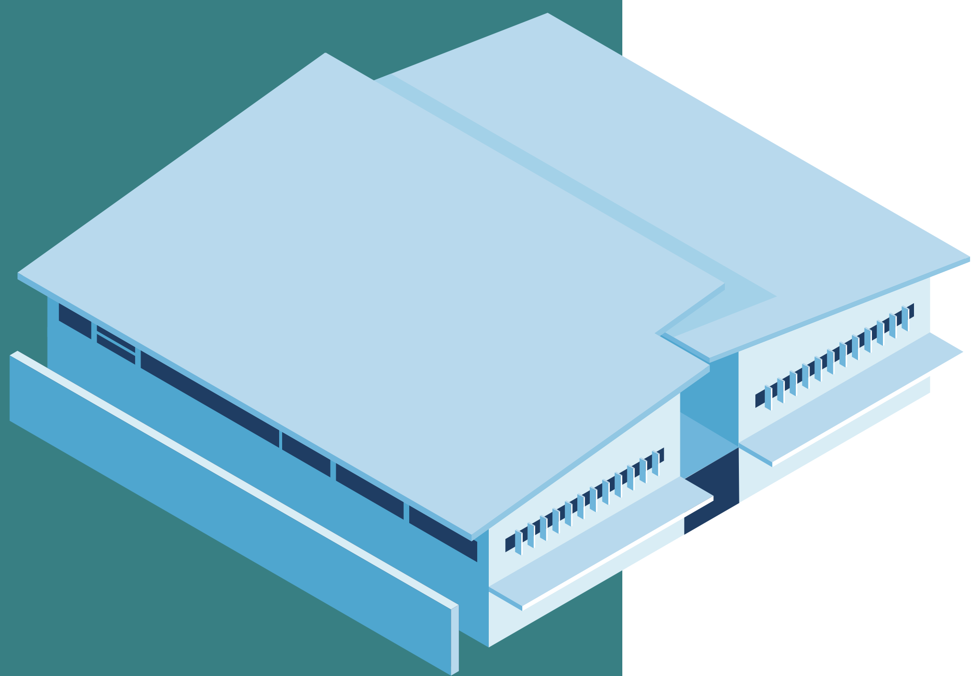
In principle, proportionate regulation can provide more diverse communities by ensuring a mixture of resident income groups within any given scheme. Bottom line, regulation is not a reason to avoid investing in the sector, but bad regulation is.

Looking behind the headlines, opportunities for the cautious and the brave

Andrew Allen

Global Head of Research, Product Strategy and Development

"We suggest investors must not compromise on quality of location and accessibility."



SEPARATE THE CYCLICAL FROM THE STRUCTURAL

The headlines for retail real-estate investors were difficult before the Covid-19 pandemic, worse through it and arguably struggling coming out of the other side. The retail real-estate market remains challenging at a headline level, but the detail is more interesting and opportunities prevail.

Once we look through the cyclical factors and assess the fundamentals, it is clear that the retail story is not all bad. And whilst we are cautious on the sector in general, retail is a broad spectrum and there are some compelling investment opportunities if you know where to look.

At the time of writing, the global macroeconomic environment is extremely tough for consumers, and will likely remain so through 2023. Inflation and the cost of finance is eroding disposable incomes, which means consumers will reduce discretionary spending and focus on necessities. Meanwhile, the steady progression of e-commerce, after retrenching a little post Covid, will almost certainly continue.

Given all this, many discretionary retailers will continue to struggle; a marginal erosion of store sales or margins has an exaggerated effect on profitability. This forces retailers to question how much they are willing to spend, or can afford, on occupation costs. Broadly it will be less.

For the best locations there is still strong competition, resulting in a concentration of quality tenants in a small number of the best areas. However, lack of demand for weaker locations creates a vicious circle of lower-quality tenants, less certain income and, consequently, lower valuations.

This will further damage mainstream shopping environments, by which we mean shopping centres and traditional high streets, where the outlook is likely to deteriorate further as demand for space decreases.

We suggest investors must not compromise on quality

of location and accessibility, although they must assess the capacity of the tenants to afford these "premium" rents. There may be an opportunity to take advantage of lower valuations as the cycle progresses, but investors should still prioritise quality.

Compelling strategies exist for the cautious

Necessity, speed, value orientation and convenience for consumers are all compelling investment cases, and our colleagues are commonly seeing the same across the UK, Europe and APAC.

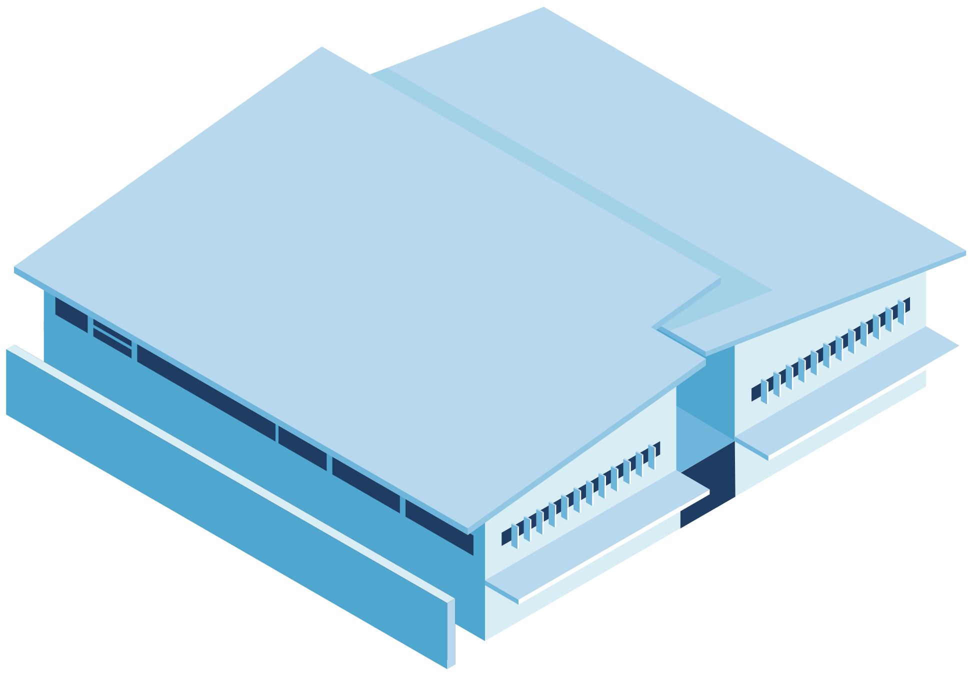
Retailers able to offer these characteristics will remain a relatively safe haven in these less certain times. These retailers retain profitability, are able to pass inflation through to consumers (or change the product mix to support margins), and their leases are commonly long and index-linked – this is a compelling proposition.

Furthermore, their offer is less vulnerable to the progression of online retail. Indeed, the stores are often part of the last-mile solution, and perhaps even priced at a discount to their urban logistics real-estate formats, which service a similar function. We strongly favour supermarkets and value-orientated retail warehousing. Indeed, this theme has global commonality, as our local teams around the world report the same consistent message.

Buy discounts, buy schemes that will weather the storm

It is all too common for all retail to be bundled together, without accurately assessing the unique characteristics of locations or assets. This will present opportunities for astute investors to capitalise on the nuances of the market.

Indeed, as we cover in other articles in this report, the growth of urbanisation, the need for many wider forms of urban property space suggests that there is likely to be considerable value in the repurposing of existing retail formats into variety of different assets within the Living sector.



Targeting the opportunities for alternative lenders

Mohamed Ali

Research Analyst,
Debt

Against the current volatile macroeconomic backdrop, the lending community is likely to be more cautious in 2023, meaning the overall supply of debt finance will be constrained in the short term. Where debt is available, it will reflect the uncertain environment, i.e. lower leverage at a higher cost.

The debt-finance market has evolved considerably since the last financial crisis, and we therefore believe this cycle is likely to play out in a different way to that which we experienced post 2008. Most notably, the average level of debt across the system (in terms of leverage) is much lower than going into the GFC[4] meaning extensive losses in the banking system and a large liquidation cycle are less likely this time round.

The provision of debt finance is now more diverse, with more funds and direct investors active across the debt-capital market. The ability of dedicated lenders to respond to market opportunities, at speed, is likely to facilitate a faster process of price discovery for both debt and equity participants. In the short term, finance availability from traditional bank lenders will remain restricted as they assess risk exposures across their portfolio[5], meaning enhanced returns available to lenders who are able to step into the gap.

Transaction flow for active lenders is likely to see a high level of refinancing enquiries as loans previously eligible for traditional bank debt now fall more squarely within the investment criteria of the alternative lenders. This will then be augmented by new transaction business as the underlying property markets reach clearing price levels, where the substantial amount of equity available is ready to commit to new purchases.

Using the UK market as an example, there is a significant volume of debt

[4] MSCI (Jun 2022)
[5] DRC Savills IM, Bloomberg (Aug 2022)

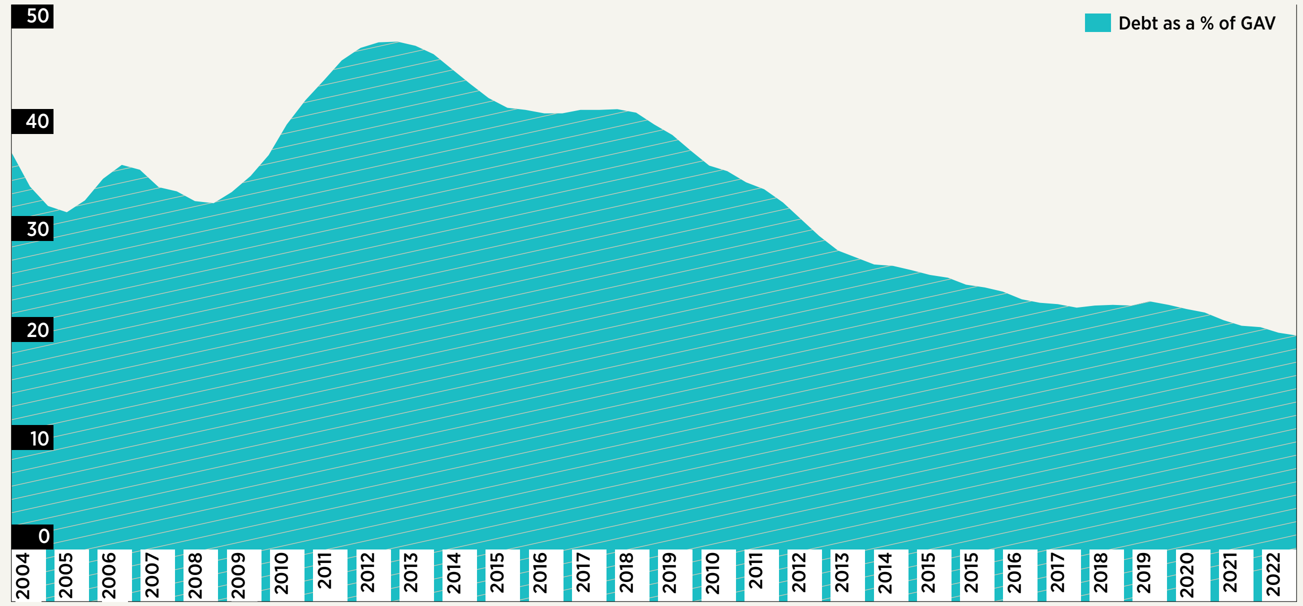
> **"45% of outstanding commercial real-estate loans are expected to mature in the next two years, rising to 75% by 2026."**

outstanding that will require refinancing. Circa 45% of the outstanding commercial real estate loans are expected to mature in the next two years, rising to around 75% by 2026[6]. Given the dramatically increased cost of debt, some well capitalised borrowers will opt to refinance by contributing fresh equity, while many others will be requiring debt from the market to fill the gap. The emergence of a funding gap in the UK will likely be significant and provide an opportunity for the non-bank lenders.

In order to estimate the size of the funding gap, we must consider several elements that drive the bank-lending criteria. For example, elevated interest rates will put pressure on property interest coverage ratios (ICRs), with the current five-year Sonia swap rate of 4.6% and assuming 60% loan-to-value (LTV) resulting in ICRs at or below one across all sectors. In order to maintain at least 1.3x ICR (as most bank lenders require), property values will need to decline by 36%[7] on average across all sectors. At the current cost of CRE debt, and assuming £76bn of outstanding debt maturing in the UK over the next five years, only £49bn would be made available to facilitate refinancing. This leaves a funding gap of around £5bn per year (£25bn aggregated) to be filled by equity or non-bank debt. Similarly, In Europe, using the same methodology, we calculate the funding gap to be similar in size to that of the UK. We expect the German and French markets to require €6.2bn and €5.1bn respectively, between 2023-25[8].

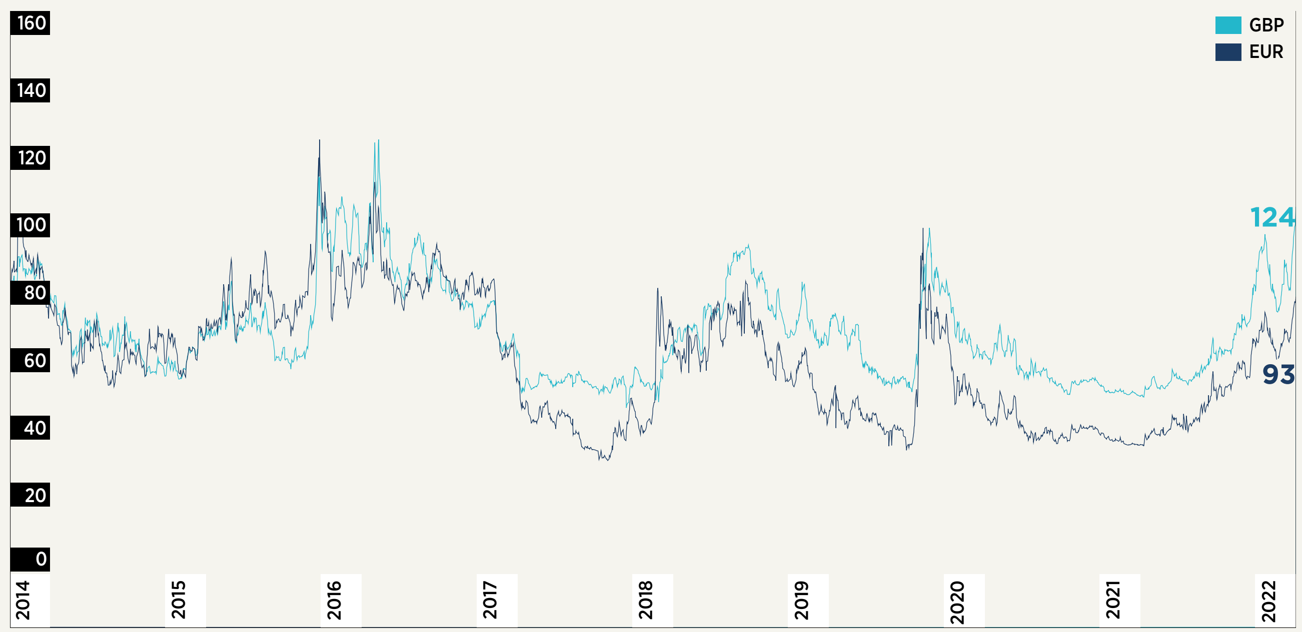
This backdrop provides a golden opportunity for non-bank lenders, who have the requisite experience to deploy capital and capture attractive premiums for their investors.

Debt levels lower than pre-GFC in Europe



Source: MSCI

Bank cost of funding on the rise



Source: DRC Savills IM, Bloomberg (Nov 2022)

[6] Bayes CRE Lending Report MY 2022 (Oct 2022)
[7] Bayes CRE Lending Report MY 2022 (Oct 2022)
[8] AEW – European Real Estate Debt Markets Re-Align (Sept 2022)

Carbon markets offer a compelling way to restore wildlife and nature

Dale Lattanzio Jr

Investment Associate,
United Kingdom

"The voluntary carbon market has grown rapidly, hitting a milestone of more than $1bn of trading volume in 2021. It is estimated that the market could scale to $50bn within the decade."

While most markets and investment managers around the world are focused on the challenges of inflation, rising interest rates and recessionary risks, the most urgent challenges we face are more existential in nature: namely, catastrophic climatic change and the accelerating collapse of our planet's life-sustaining ecological systems.

In its Living Planet Report, The World Wildlife Fund (WWF) revealed that 69% of the world's wildlife was lost between 1970 and 2018[9]. To put these staggering losses into context, an investment that falls by 69% needs a 220% recovery to regain its losses. An 80% loss requires a 400% gain.

More than half of the world's GDP is derived from natural resources; It is unequivocal that the challenges posed by degrading natural resources and anthropogenic climate change have set an extraordinary task[10].

An urgent solution is needed, and markets are responding. The rapid development of the voluntary carbon market and biodiversity markets suggests that investors are waking up to the opportunity to participate in the restoration of the biosphere.

The voluntary carbon market has grown rapidly, and in 2021 it hit a milestone of more than $1bn of trading volume. However, it is estimated that the market could scale to $50bn within the decade.

[9] WEF: https://www3.weforum.org/docs/WEF_New_Nature_Economy_Report_2020.pdf
[10] WWF: https://wwflpr.awsassets.panda.org/downloads/lpr_2022_full_report_1.pdf
[11] VCM: https://www.iif.com/Portals/1/Files/TSVCM_Report.pdf

A better approach to farming and nature

Farmland & forestry have become staple alternative investments in many portfolios due to their strong diversification characteristics – they are uncorrelated to traditional assets and have provided consistent returns to investors.

Now, as a result of the voluntary carbon market, farmland and forestry investment is taking on a new dimension. The importance of net zero targets and nature's ability to provide climate solutions is changing the dynamics of land investment. By targeting investment not only in commercial timber, but also into natural capital, investors are gaining the ability to create nature-based solutions and generate verified carbon units (VCUs).

Specifically, a VCU represents one tonne of carbon that has been sequestered from the atmosphere, or avoided from being emitted. A VCU can be used to credibly offset one tonne of residual emissions that is challenging to avoid.

The creation of high quality VCUs requires the active enhancement of ecosystem services and delivery of a long-term business plan. The shift in focus from optimising commercial yield to creating resilient ecosystems necessitates new land-management techniques.

A range of regenerative management approaches have emerged as a way to deliver economic value whilst maintaining a disciplined approach to improving ecological health. The evolving techniques outlined below are all grounded in the principles of strengthening ecology.

Sector Statistics

69%
of the worlds wildlife was lost between 1970 and 2018

A fall of 69% requires a
220%
recovery

$50bn
the potential value of the voluntary carbon market in the next decade

Regenerative Agriculture characterised by the following principles: limited soil disturbance, cover cropping (constant plant coverage), no synthetic pesticides or fertilizer, and the integration of livestock to create living systems.

Perrenial Cropping Managing perennials prevents soil erosion, sequesters carbon, and supports pollinator health.

Afforestation & Continuous Cover Forestry Planting & management of forests without clear fell harvesting.

Peatland Restoration Restoring peatland returns critical habitats to their original form, locking up greenhouse gases and improving biodiversity.

When implemented, regenerative management sequesters carbon, enhances biodiversity, improves the water & nutrient cycle, and fundamentally bolsters ecological resilience. Although the market standards and perspectives around nature-based solutions are still evolving, the importance of these marketplaces to our planet is clear. We would be delighted to share our more detailed insights with clients.

Urban Industrial & Logistics will weather the storm better than most

Christian Müller

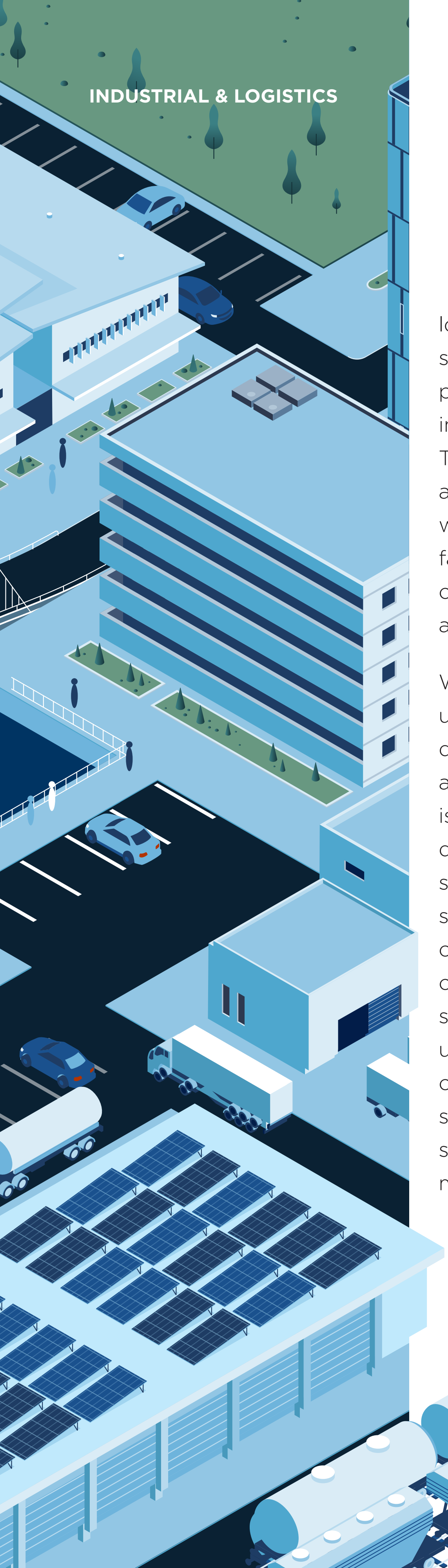
Head of Research & Strategy, Germany

"The structural imbalance of demand and supply will drive rental growth prospects in the medium-to-long term."

The standard distribution logistics sector proved its resilience at the height of the pandemic. It fulfilled its supply mandate superbly, and is expected to continue its strong performance despite the current challenging economic environment.

Due to long-term trends such as advancing urbanisation and e-commerce, the "Urban Logistics & Light Industrial" sector will benefit more than most, adding to opportunities in income-resilient sectors such as housing, big-box logistics and food retail.

The sector's key strengths are driven by both the demand and supply sides of the occupier market. Continued urbanisation will generate long-term demand for urban industrial and



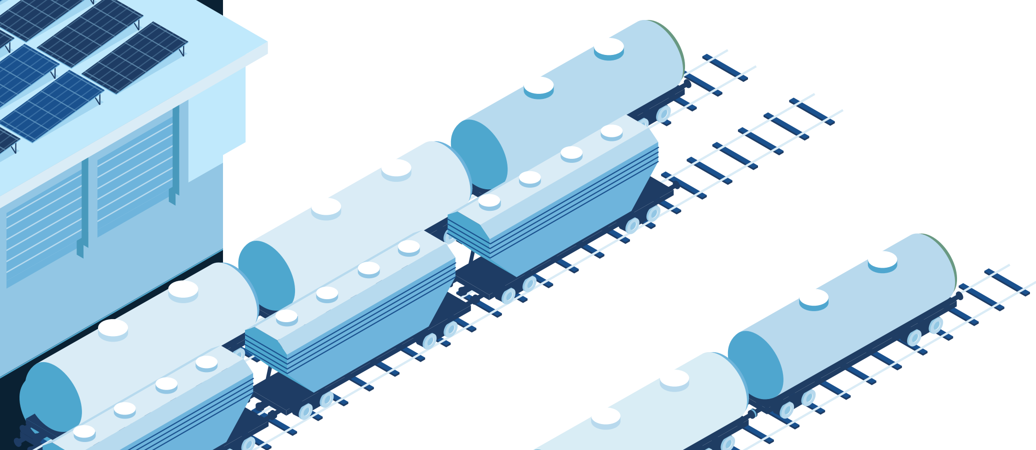
logistics, and commercial space, to supply the growing populations and economies in the local towns and cities. The proximity to customers and urban sales markets will become the decisive factor for configuring supply chains efficiently, diversified and sustainably.

While e-commerce is usually in the spotlight, the demand for urban logistics and light industrial space is much broader. Sound demand for modern urban space is expected from smaller to medium-sized occupier groups, which contribute to the overall supply chain of the local urban manufacturing and commercial industries, such as wholesale, logistics service providers or light manufacturing.

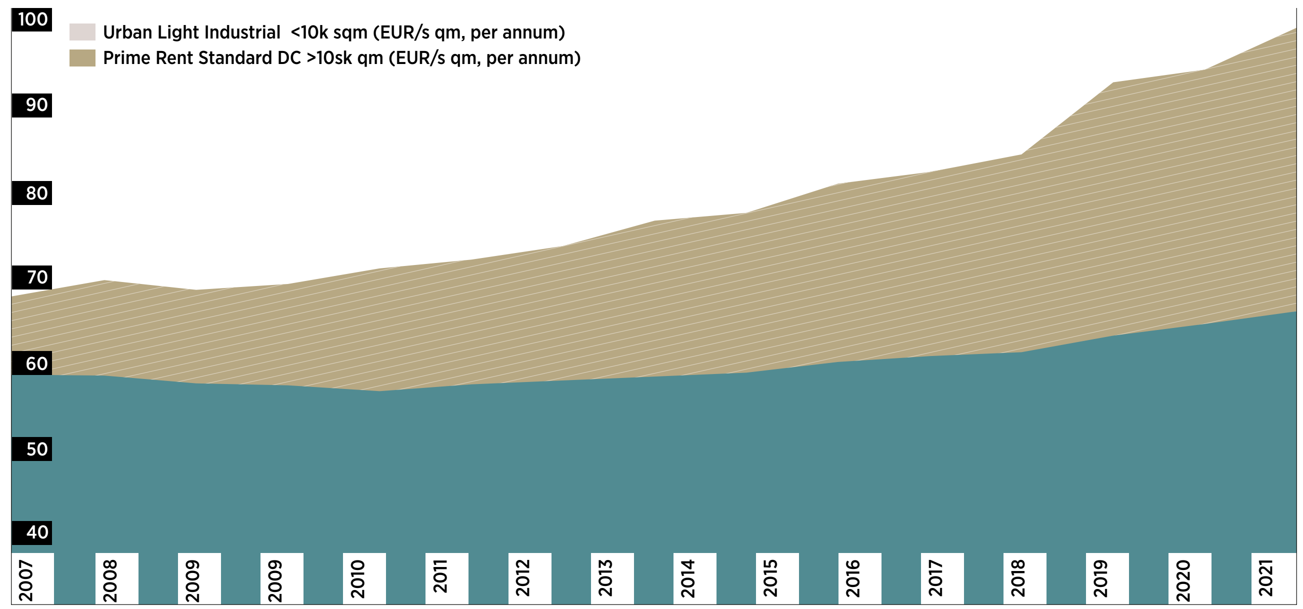
At the same time, the supply side is extremely tight, and tightening. There is hardly any modern urban logistics and light industrial space available in and around key European towns and cities. New construction activity is very limited due to a lack of available industrial land and the competition with residential developers. Moreover, the EU's target for "no net land take by 2050" will further limit the designation of new developments to reduce land consumption, which will ultimately lead to an increased densification of urban areas, mitigate urban sprawl and reinforce land-supply constraints.

This structural imbalance of demand and supply will drive rental growth prospects in the medium-to-long term for the urban industrial and logistics sector. On the supply side, however, there is another component which comes into play: a largely obsolete building stock. We see opportunities in upgrading large parts of the current Industrial & Logistics property stock in urban locations, creating significant value-add potential through upgrading measures, repositioning strategies and active asset management to create best in class, ESG-compliant industrial space.

In summary, we believe that the urban logistics & light industrial sector is very well positioned to overcome the cyclical macroeconomic challenges that we face. The structural supply and demand imbalance will create market resilience, complemented by the potential for value enhancement, which should cushion cyclical risks very well.



Urban Logistics and Light Industrial – Sound Income Prospects in Europe*



Source: PMA, Savills IM

*Antwerp, Brussels, Lyon, Paris, Berlin, Dusseldorf, Frankfurt, Hamburg, Munich

Gap between “best” and “the rest” grows in European office market

Hamish Smith

Head of Research & Strategy,
United Kingdom

Matteo Vaglio Gralin

Senior Analyst,
Southern Europe, France

“Investors need to pay more attention to future leasing risks and capital expenditure requirements.”

In the post-covid world the office remains essential for many businesses. But what tenants want is changing fast as they adapt to new working habits and focus increasingly on higher quality, well located and more sustainable buildings.

Realising that such characteristics are important to attract and retain talent, tenants are prepared to pay more for buildings that meet these requirements. They can increase productivity and offer greater operational efficiencies (especially at times like now) along with lower carbon emissions.

All of which is altering the risk-reward profile of offices, which investors need to understand and adjust to.

Much of today’s stock doesn’t meet the needs of tomorrow’s occupiers. Moreover, of the stock that does, availability is low. For this type of building – best-in-class, Grade A space – a demand-supply imbalance (which is likely to be made more acute as development activity is put on hold by rising costs) should help quality offices weather the current period of repricing better.

What's more, this structural change in tenant requirements presents an opportunity for value-add strategies. Essentially creating the next generation offices from existing, well located Grade-B stock that can be brought up to scratch cost effectively while satisfying net zero carbon requirements.

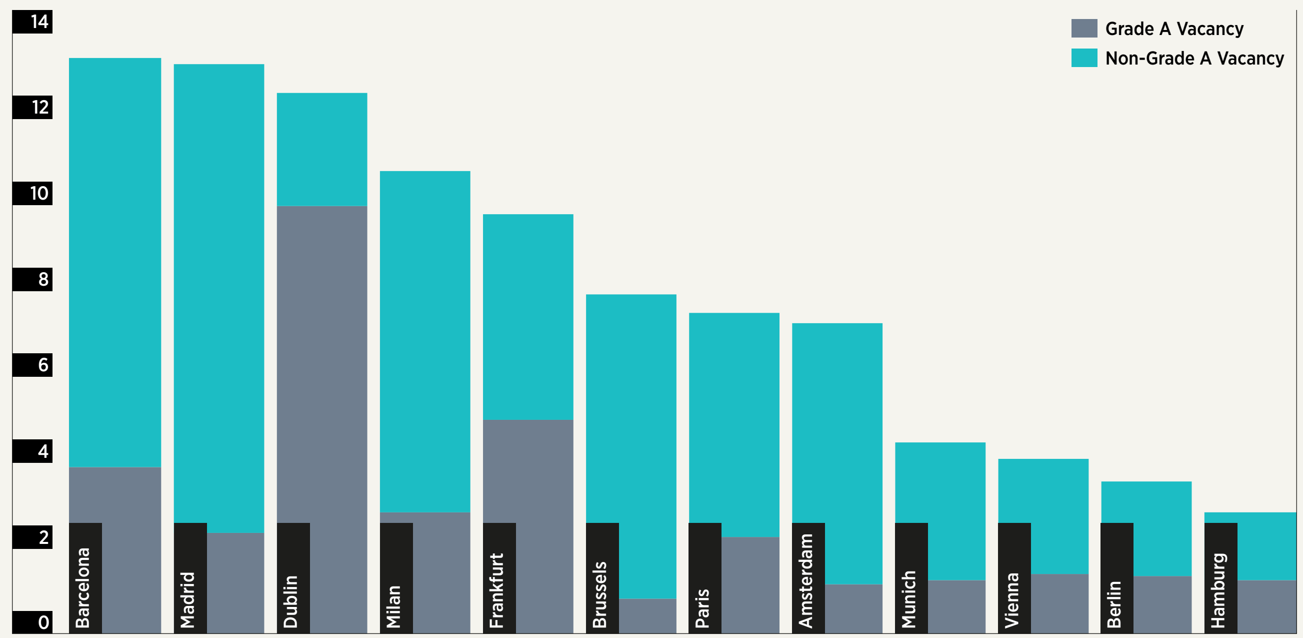
As tenants demand more from their office space, however, we expect this to translate into greater capital expenditure in order for buildings to remain attractive. As a result, the ability to generate rental growth to offset higher costs is a must. Existing stock that is too expensive to upgrade or is simply in the wrong location, is at most risk of obsolescence. This is something we believe investors need to consider carefully in acquisition plans.

To be fair, not all businesses can afford, or are prepared to pay for, space with all the bells and whistles. There will always be a need for cheaper space for smaller firms, particularly start-ups. But even they are still likely to demand space that meets certain minimum sustainability levels which we suspect could mean an effective de facto minimum standard of what an investible office must have in the future.

Investors also need to pay more attention to future leasing risks and capital-expenditure requirements. As tenants also demand more flexible leases today, no longer can investors sit back and collect a quarterly coupon for 10 or 15 years. As leases become shorter, this reduces the security of future income for investors, which all else equal, increases the risk profile of the asset. In other words, investors are likely to need to allocate more expenditure for less certain income.

This doesn't mean to say the office doesn't have a future in a real-estate portfolio, but understanding the greater risks in the sector is a must. Indeed, we believe investors should focus on well-located Grade-A space as well as considering opportunities to improve existing assets in good locations. But we expect there to be a greater dispersion in asset performance in the future, with a fine line between easily lettable, good quality non-prime stock and the asset becoming unlettable and at risk of being obsolete.

European Office Vacancy (%)



Sources: CBRE, Savills IM

Asia Pacific

Opportunities to counter western volatility

Shaowei Toh

Head of Research & Strategy, Asia Pacific

"Growth prospects across Asia Pacific will undoubtedly be impacted by global events in the near term, but we expect GDP growth to pick up within the next 18 months."

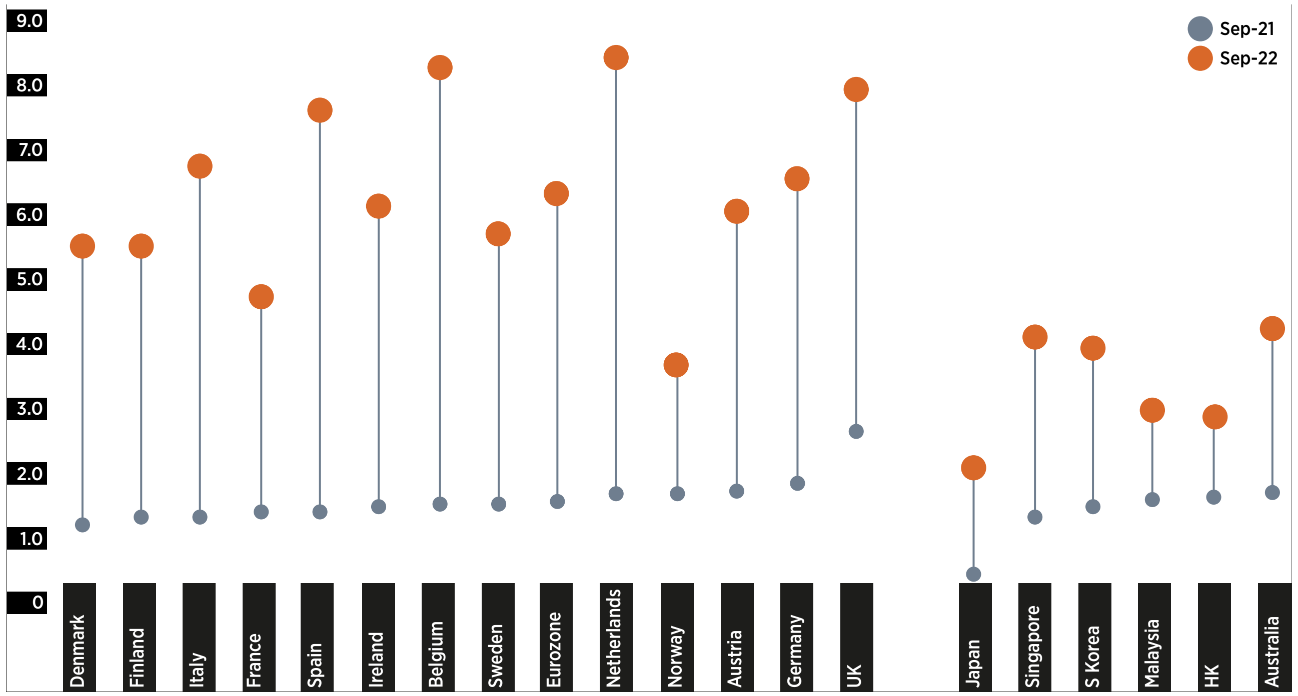
There is a growing consensus that the Asia Pacific is emerging as a relatively safe harbour in these turbulent times. Price pressures are relatively subdued in most of Asia, which suggests that central banks may not follow Western economies with aggressive rate hikes.

Why is inflation less aggressive in the Asia Pacific? For a start, the region initiated more effective pandemic management measures than western counterparts. Even at the peak of the pandemic, nationwide lockdowns were not the preferred tool of containment in developed Asia.

In fact, most Asian countries took a highly targeted approach towards the restriction of mobility. Economies were also reopened far more gradually than in Europe. This has helped to prevent a major demand shock which could well have led to more intense price pressures. The jobs markets also held up well, with the unemployment rate peaking at 7.5% in Australia, and at 3.1% in Japan. Keeping people in their jobs ensured that manpower is now readily available and hence wage inflation is not a problem.

It is unusual for rents in Asia Pacific to be indexed to inflation. Historical market data from the past two decades confirm that rents in Asia are more correlated with GDP growth than with inflation. Growth prospects across Asia Pacific will undoubtedly be impacted by global events in the near term, but we expect GDP growth to pick up within the next 18 months. As at 10 October 2022, more than 70%[1] of Asia's population had been fully vaccinated. This compares favourably with the global average of 63%. In developed markets such as Australia, Japan, Singapore and South Korea, the vaccination rate is above 80%. This puts many Asian markets in an excellent position to reopen.

Inflation forecast for 2022 (as at Sept 21 vs as at September 22, %)



Source: PMA

In the absence of high inflation, we are optimistic about the medium-to-long term growth prospects of the region, and we stay constructive on real estate occupier performance.

All said, we know the increase in returns on government bonds will have to pass through to real estate valuations. It is no exception in Asia, but the jury is still out on the extent and timing of the market re-pricing. There are two conflicting forces at work in the potential repricing of real estate in Asia. Despite the increase in policy interest rates, commercial property yields are generally priced off long-term government bonds, and the long end of the yield curve has not moved up as much.

This has helped to stave off a sharp fall in capital values. However, the cost of financing has already edged up significantly in many Asian markets. Other than underwriting negative spreads, interest coverage ratios and cashflow projections are being threatened. It is a fact that loan-to-value (LTV) in Asia has been modest after the GFC, but there is still the risk of a shortfall in re-financing availability as financiers become risk averse. Investors have their work cut out for them, but there is comfort in the fact that the underlying rent performance is resilient across many Asia Pacific markets.

As interest rates normalise, the income component becomes essential in driving total returns in real estate. In the five years before COVID-19, capital value growth contributed in excess of 45% of the total returns from commercial real estate in Asia Pacific. Going forward, capital value growth is likely to be much lower, making up just a third of total returns, while income will drive more than 60%. Investors and asset owners who are reliant on the capital growth to do their heavy lifting will start to feel the drag on performance. In contrast, investors and asset owners who are commit to active asset management will be rewarded. That is to say, those that embrace changing trends and focus on maximising value from every asset rather than relying on an ever-rising market to do the work, will be well rewarded over time.

Sector Statistics

3.1%
peak unemployment rate in Japan during Covid pandemic

70%
the proportion of the APAC population that has been fully vaccinated against Covid

≈4.4%
Forecast inflation rate for APAC in 2022

Spotlight on South Korea

Intense competition for assets meant that the South Korean real estate market delivered a standout performance during the pandemic. According to MSCI data, South Korea makes up approximately 4% of the investable real estate universe in Asia Pacific, but it commanded a disproportionately large share of investment activity in 2021. In fact, South Korea was ranked third, behind China and Australia, in terms of the volume of investment. On a city-level, Seoul edged out traditional heavyweights - such as Tokyo, Shanghai and Sydney – and saw the highest level of transactional activity in 2021. As at the time of writing, commercial real estate investment volumes in the first half of 2022 have already matched that of 2021.

The real estate scene has traditionally been dominated by domestic investors. Before the pandemic, domestic investors made up, on average, 80% of investment activity in Seoul annually. With the onset of the pandemic, that has increased to around 90%, going as high as 96% in 2021. Many cross-border investors struggle to get access to deal flow and capital partners, and even when they can, intense competition means that finding assets at a reasonable price is challenging.

SAVILLS IM AND SAMSUNG LIFE – A NEW STRATEGIC ALLIANCE

In December 2021 we entered into a strategic alliance with Samsung Life, Korea's leading life insurer and its real estate asset management subsidiary, Samsung SRA. We expect the partnership will enhance and accelerate our ability to provide attractive investment products for our institutional clients. For 2023 and beyond, our partnership will be instrumental in our growth plans.

Savills IM's APAC analyst, Shao Wei Toh, explains how investors can benefit from access to this fast growing, dynamic and perhaps less understood market.

Given that it will inevitably be impacted by the global challenges, the short-term downside risks are clear. Nevertheless, we still believe the South Korea commercial real estate market will be an attractive value play, and an obvious consideration for investors looking to diversify across the region.

We expect the economy to expand by at least 60% in the next decade

96%: the level of domestically orientated investment activity in 2021

Dynamic economy

South Korea's nominal GDP has increased from approximately US $500 billion in 2001 to US $1.6 trillion in 2021. We expect the economy to expand by at least another 60% in the next decade. As a global leader in innovation and technology, the Korean economy is well positioned to ride the next global wave of technology-driven evolution.

For instance, while remote working has planted roots, only a third of companies actually have a work-from-home policy. This compares to more than 45% in many European markets. On another note, even though the e-commerce penetration rate is relatively high, the per capita provision of high-quality logistics stock is considered low. These points both support the case for office and logistics rent performance.

Occupier demand is strong

Occupier performance has been robust. This is largely due South Korea's effective pandemic management. According to Savills Research, the office vacancy rate in Seoul was 4.9% in Q2 2022, with the Gangnam Business District recording a low of 1.6%. Effective rents in the office sector have increased by around 12% in the last two years, and we are forecasting further growth of approximately 10% to 12% in the next two years.

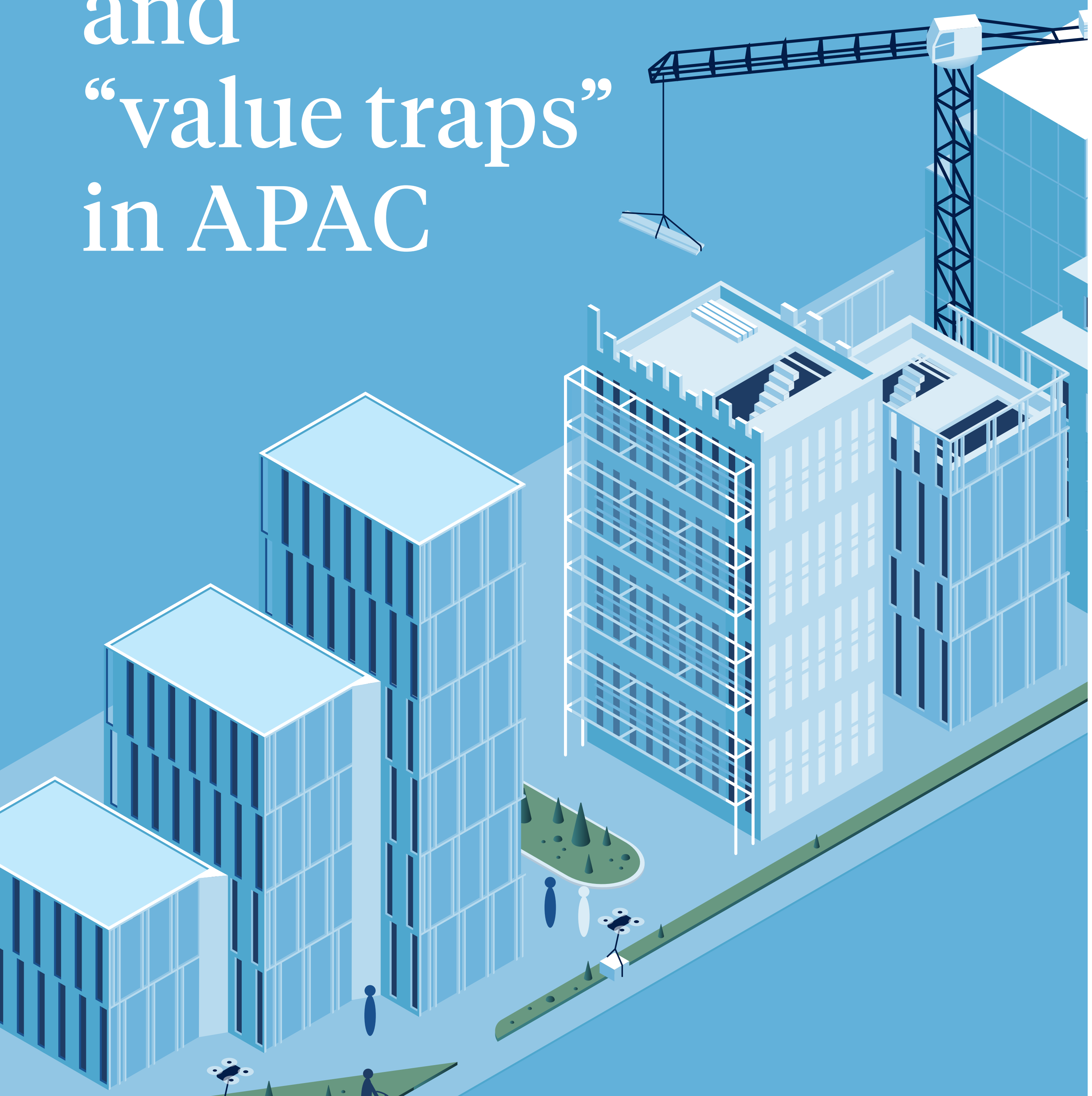
Demand side risks are increasing, as is the case globally, as reflected in the increasing cost of financing in South Korea after a few rounds of rate hikes. We expect the aggregate office cap rate in Seoul to expand by around 30 basis points over the next two years. At the current level of yields, rents will have to increase by around 8% to offset the full impact of this cap rate expansion on capital values. With rent growth forecast to come in at between 10% to 12%, the Seoul office market is expected to perform relatively well in comparison to many Western office markets.

Institutional inflows

We are of the view that the introduction of more institutional investment into the South Korean real estate market still has a long runway. The experiences of other markets such as Japan, Singapore and Australia offer insights into how institutional involvement can benefit the real estate market. For example, the on-going development of the listed REIT sector in South Korea will herald in an important era of retail investor participation. Other than increasing the access and exit options for institutional investors, the price discovery process will become more efficient. We have already seen that happen in other Asia Pacific markets. Finally, while it may not necessarily happen in the immediate future, the potential re-classification of South Korea into a developed market in the MSCI indices will definitely stimulate capital inflows into the market.

There is no disputing that 2023 is likely to be a challenging year, but investors who are able to work with strong local operators and capital partners are likely to extract significant value from this dynamic market with fundamentally appealing characteristics.

"Value tracks" and "value traps" in APAC



Japan multifamily continues to outperform

Population growth and changing lifestyles have increased the propensity to rent amongst urbanites. While the national population of Japan is declining, positive net internal migration has been driving population growth in key cities. According to the Japan Statistics Bureau, the age of first marriage in Japan has been progressively increasing over the years. This means more people are renting for longer, and in smaller properties.

For example, Greater Tokyo was home to approximately 37 million residents as of 2021. Yet data from 2018 shows more than 50% of dwellings were rented. Greater Tokyo also accounts for more than 70% of overall multifamily transaction volumes in Japan each year. Importantly, the cost of borrowing in Japan remains relatively low, which translates into solid yields - despite intense competition for stock.

Essential retail a solid defence

The pandemic has already demonstrated the resilience of essential retail. In the next few years, we expect essential retail formats to continue to outperform as real wage growth remains subdued and consumers cut back on discretionary purchases. Specifically, we think there is a sweet spot in neighbourhood retail formats, weighted towards the non-discretionary trade-mix, and located close to population centres.

The ESG awakening: Flight to quality in the office sector

In the office sector, remote working is set to become more prevalent. The good news is that outside of Australia, most APAC office markets are not major converts to the hybrid working format, although it is still a clear trend. As businesses plan for life after the pandemic, the 'hub-and-spoke' office model is fast gaining traction. With hybrid working becoming more entrenched, a firm may now look to retain a CBD office location and augment it with a satellite office.

What is considered 'quality' in the office sector these days? It is no longer just about location. A well-provisioned office building in a suburban area can be considered a high-quality asset. Increasingly, office tenants are looking to ensure that the environmental impact and the provision of amenities are just as important. Investors would do well to adapt to this movement.

We expect a widening dichotomy within the office markets of Asia Pacific. For example, in the six years prior to the pandemic, prime CBD office rents in Sydney more than doubled. Affordability constraints and concerns over the timeline of business recovery are pointing to a reassessment of suburban office precincts that are in close proximity to the city, as well as residential and transport catchments. The same could be said of many gateway cities in Asia Pacific. We therefore think that good quality office assets sitting in selective non-primary locations could present good value as rent growth could outpace the overall market rent growth.

Emerging segments: Keep your foot on the pedal

In such uncertain times it is easy to become overly defensive. However, the next few years may well present a unique opportunity for investors to get into emerging opportunities in the real estate space. We think areas such as healthcare real estate and alternative storage solutions are potentially attractive propositions. Ageing populations and the liberalisation of private insurance in Asia Pacific are key drivers of healthcare needs such as hospitals and senior living. In the latter, the rise of the middle class in Asia will support the demand for protein consumption and pharmaceuticals, which rely on cold storage facilities. On the business-to-consumer front, self-storage demand is booming in Asia, driven by the growth of e-commerce, shrinking living spaces and higher population densities.

Clearly, emerging and niche asset classes require significant operating expertise, and investors would do well to look out for well-priced opportunities arising from investor hesitancy.

Value Traps

Prime retail yet to convince

Even before the pandemic, prime retail in most Asia markets was struggling. In Japan, for example, department stores and high fashion brands struggled to stay above water, but drugstores and pharmacies attracted record footfall. We are not sounding the death knell for retail, but the pandemic has had its impact. Prime retail values have declined by more than a third in some cities. This has certainly attracted interest from investors looking to buy the bottom, with the view that the intrinsic value of retail will be realized gradually. Most others simply see this as a fire-sale, with the hope that the re-opening of borders will change the current narrative.

In gateway cities in Asia Pacific, a significant proportion of pre-pandemic retail sales can be attributed to tourist spending. Even with international borders re-opening, the Asia Pacific retail scene is sorely missing the Chinese tourist. We would caution against investing into prime retail assets with the hope that business will bounce back quickly.

Beware the wrong end of the logistics bandwagon

The logistics bandwagon continues to roll in Asia Pacific. With a low level of modern logistics stock and continuing e-commerce growth, most Asian markets have a structural deficit in warehousing and logistics space. Some investors might now seek refuge in logistics, but we think a discerning approach is needed.

Even before the pandemic, the warehousing sector was underwritten more on capital growth than on income growth. Third-party logistics tenants operate on very tight margins and rental growth was seldom ahead of inflation. As cap rates have compressed over the last two years, capital growth has become elusive. In fact, at low levels of cap rates, the logistics sector will face an outsized impact due to yield expansion. Is it then the time to buy?

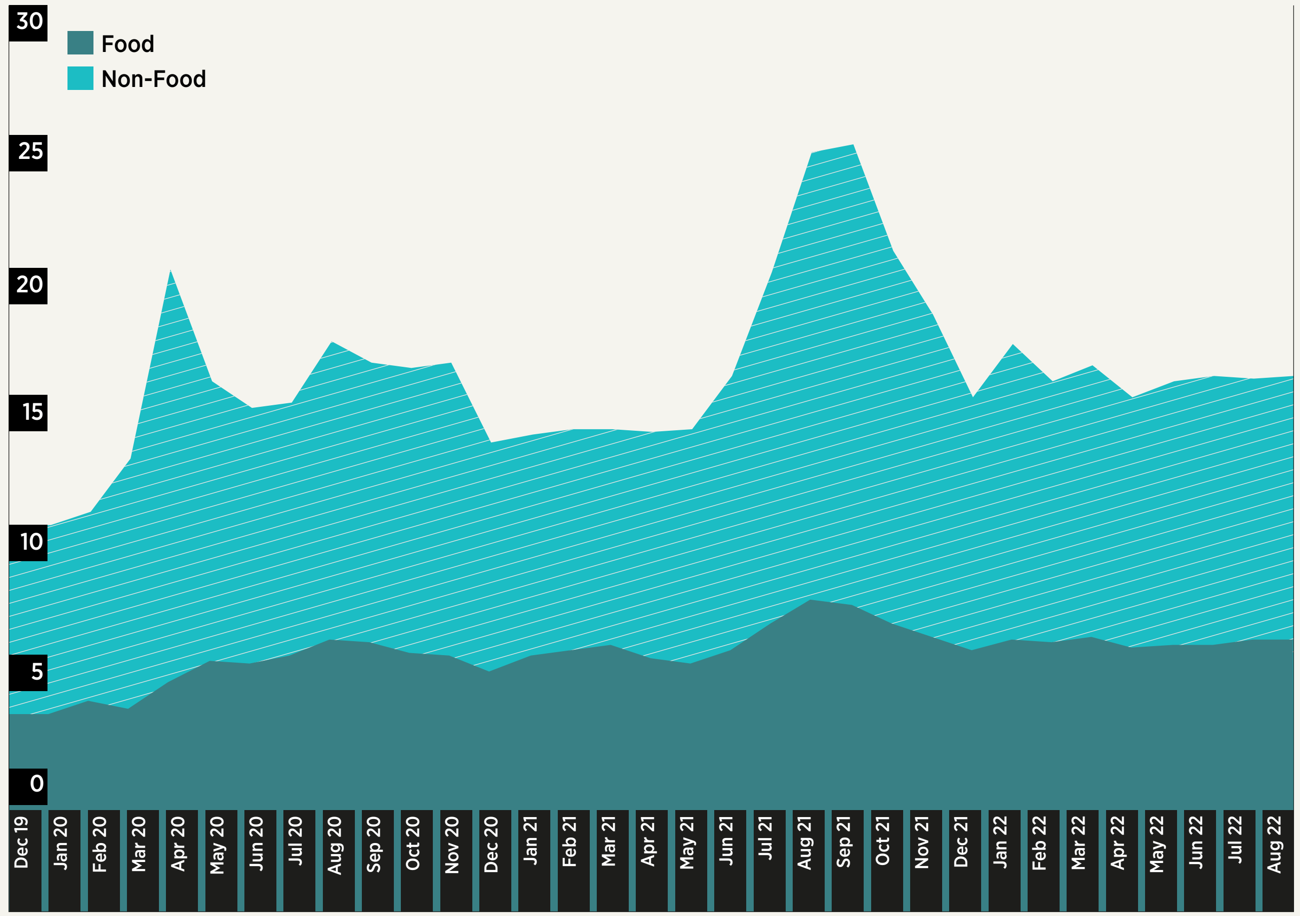
We still like the logistics sector. The underlying secular themes are strong, and income is stable. However, investors looking to buy into large distribution hubs might want to be more cautious. As e-commerce players start to compete on fulfilment and time to delivery, the spotlight has turned towards urban logistics located close to population hubs with strong transport links. The obsolescence risks of large-scale logistics facilities have increased, and that can only be compensated by a disproportionate decrease in the entry price. Also, tenants now place a greater emphasis on ESG-compliant logistics assets which can also bring about efficiencies in running costs.

Overall, we advocate that investors take a more granular approach towards logistics investment, avoid speculative development and focus on identifying assets and locations that are future-proofed.

Superficial asset refurbishment

The APAC commercial property sector is facing heightened risks of obsolescence. Even before the pandemic, capital expenditure as a percentage of operating income in the APAC office market had doubled from approximately 10% to 20% over a decade. We estimate that approximately half of investment properties in Asia Pacific are at least twenty years old. Ageing buildings are par for the course in markets such as Japan and Hong Kong. Given that rents in ageing or outdated buildings are estimated to be as much as a third lower than comparable newer buildings, there is potentially financial upside for investors in modernising assets. This also ties in closely with the ESG angle, where the re-development and refurbishment of buildings are our preferred ways to capture any green premium.

Australia – Online retail as percentage of total retail for Food and Non-Food categories



Source: Australia Bureau of Statistics

That said, there is still a limit to how much ESG-related premiums can be extracted from refurbishment efforts. Construction costs may stay elevated in the near term, which also means that the financial benefits of asset enhancements and refurbishments may be slow to materialise. Investors should be wary of embarking on asset enhancement initiatives that are superficial at best, all in the name of ESG. In addition, many old offices that are located far from transport hubs, or are situated near secondary train stations, have seen a larger fall in occupancy and rents. In other words, location is still key.

Contributors

Andrew Allen
Global Head of Research, Product Strategy and Development

Matteo Vaglio Gralin
Senior Analyst, Southern Europe, France

Hamish Smith
Head of Research & Strategy, United Kingdom

Adam Alari
Head of Living Research & Strategy, Europe

Shaowei Toh
Head of Research & Strategy, Asia Pacific

Christian Müller
Head of Research & Strategy, Germany

Jon Crossfield
Head of Strategic Partnerships and Living

Mohamed Ali
Research Analyst, Debt

Dale Lattanzio Jr
Investment Associate, United Kingdom

With thanks to Ellen Heinrich, Michelle Sartorio, Marta Lopes, Nick Gardner, Grainne Keogh, Sarah Jones, Paul Tkachenko.

VISIT THE WEBSITE

savillsim.com/digital/outlook-2023

ABOUT SAVILLS INVESTMENT MANAGEMENT

Savills Investment Management ('Savills IM') is a specialist real estate investment manager investing in Equity and Debt real estate strategies on behalf of a global institutional investor base with more than €26 billion* in assets under management. Savills IM is headquartered in London, UK and has 17 offices in 14 countries with over 380 staff including 154 investment professionals globally.

Savills IM was formed in 1987 as a division within Savills Group a leading global real estate services company with 700 offices across 20 countries which offer a full spectrum of real estate services. In 2003 the fund management arm was split out into a separate company. Savills IM is majority owned by Savills Group with Samsung Life owning a minority stake.

*as of 30 September 2022

savills | investment management

savillsim.com/digital/outlook-2023

Scan the code to view the Outlook 2023 report