3Q21

QUARTERLY INSIGHTS | INVESTMENT RESEARCH

# ASIA PACIFIC

## Key Themes

- Acceleration of Vaccination Will Be Key to Maintaining Economic Recovery Momentum in Asia Pacific
- Is Recovery in Sight for Hotels?
- In the Hunt for Yield, Will Capital Start (Re)Turning to Retail?

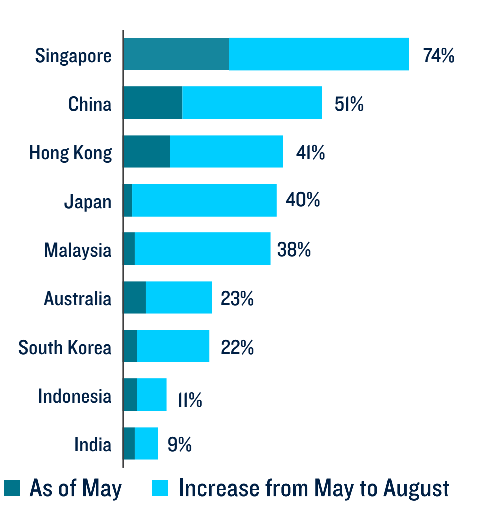
## Acceleration of Vaccination Will Be Key to Maintaining Economic Recovery Momentum in Asia Pacific

Until the early months of 2021, developed Asian countries were usually referred to as success stories in containing the COVID-19 pandemic, and the Asia Pacific region was expected to lead the world economy in the recovery phase. But even though economic growth has been rebounding strongly in many Asian countries, slow rollouts of COVID-19 vaccination have erased Asia's early advantage in managing the pandemic, thereby delaying relaxations of social-distancing measures and adding complications to the outlook, particularly in Australia, Japan and South Korea (exhibit 1).

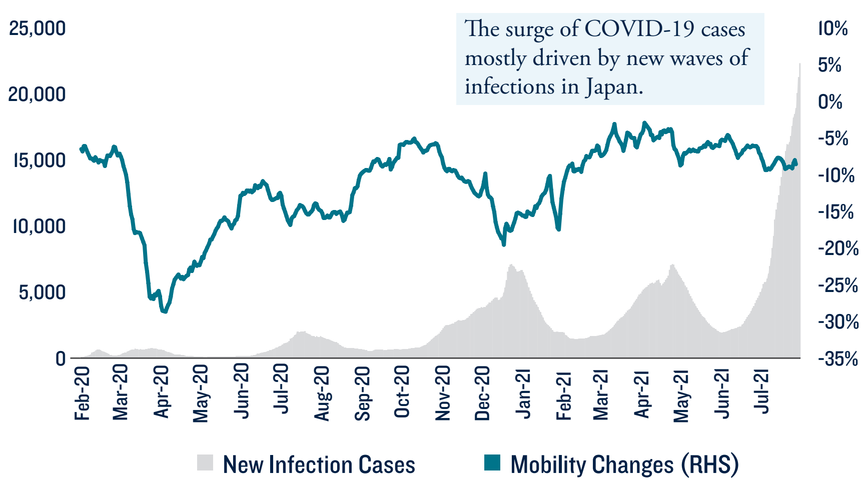
As of August, vaccination progress, as measured by percentages of populations fully vaccinated, varies widely among major Asian economies. It ranges from the highest vaccination rates in the world—for example, 74% in Singapore—to the lowest among developed economies—at a low 20% in Australia and South Korea (exhibit 1).

**Exhibit 1: Vaccination Rates and Mobility Measures in Asia Pacific**

**Percentage of Population Fully Vaccinated (As of August 20, 2021)**




**New Infection Cases & Mobility Changes (Developed APAC, 7-Day Rolling Average)***




Note: New cases are daily totals including data from 5 countries: Australia, Japan, Hong Kong, Singapore and South Korea. Singapore cases exclude dormitory cases. Mobility changes (excluding Residential) of the same countries are compared against early 2020.

Sources: Google, CEIC, PGIM Real Estate. As of September 2021.

Countries such as Singapore where majority of its population is vaccinated can now consider taking steps to gradually relax social distancing and mobility restrictions, including permitting more people to return to their offices and reopening borders to travelers from selected countries. And even though risks from new variants of the virus remain, it has become clear that achieving high vaccination rates is critical to lowering the risks of complications from new waves of infections to maintain economic confidence and the momentum of the recovery.

Looking beyond the initial setback, many Asian countries have made significant progress in rolling out vaccines in recent months (exhibit 1). Japan and Hong Kong have now vaccinated 40% of their populations, starting from very low numbers in May. South Korea and Australia are still lagging, but their vaccination programs are also gathering pace. At their currently accelerated levels of progress, major Asian countries are expected to have vaccinated the majority of their populations by the fourth quarter, supporting prospects of a continued and broadened economic recovery.

The Asia Pacific economy is forecast to grow 6.5% in 2021 and 4.9% in 2022, according to Consensus Economics in August.

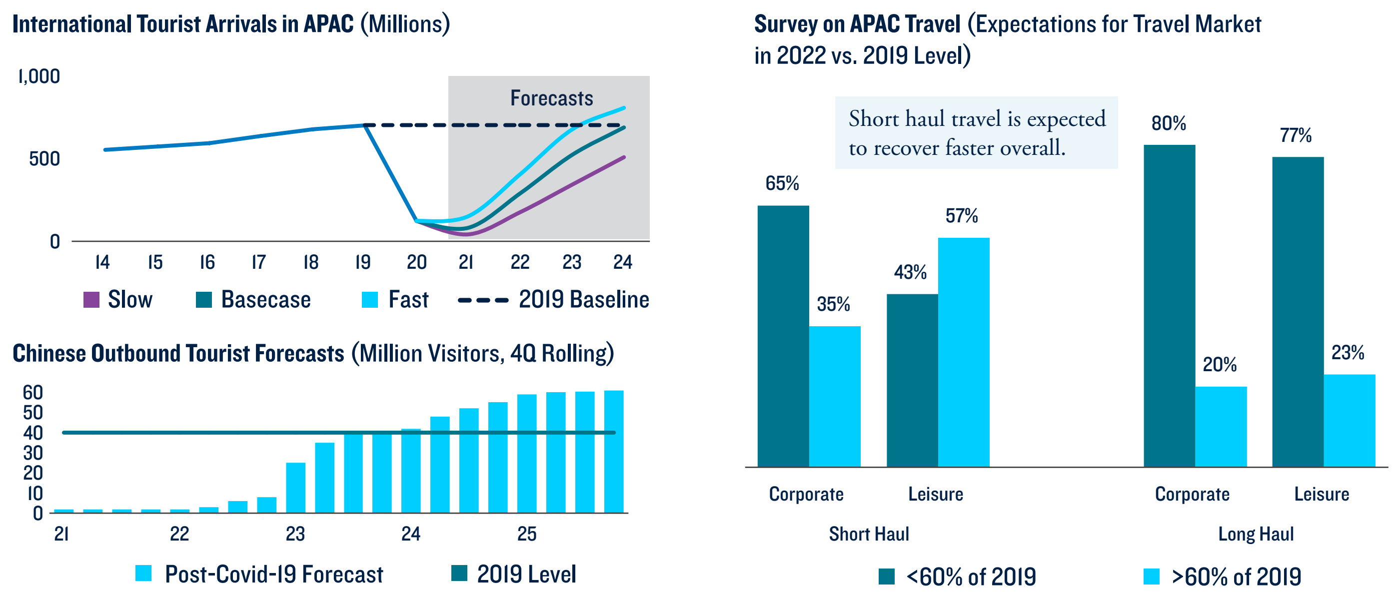
## Is Recovery in Sight for Hotels?

With the pandemic keeping most of the world grounded, hotel occupancy rates in Asia Pacific fell sharply—to an average of 30 to 40%—in the past 12 months, which arguably represents the toughest crisis the tourism sector has ever faced. However, with the significant progress in increasing vaccination rates, we believe the worst of the pandemic has passed and a recovery is in sight. The Pacific Asia Travel Association forecasts tourist arrivals to recover to pre-pandemic levels by end 2024 (exhibit 2).

The recovery of international travel will be heavily dependent on the willingness and ability of Chinese tourists to travel. Before the pandemic, China had been contributing significantly to the growth of international tourism globally—and particularly so in Asia Pacific. Hong Kong, for example, relied on China for over 70% of its cross-border arrivals, and other major markets saw 10 to 35% of their international visitors from China. With China's authorities making a major push for vaccinations in the second quarter of 2021, the Economist Intelligence Unit estimates that Chinese outbound tourism will return to pre-pandemic levels by mid-2023, thereby supporting expectations of international tourism recovery in the Asia Pacific region in 2023–24 (exhibit 2).

However, with cross-border travel remaining largely closed currently, domestic travel will be a dominant source of demand for the hotel sector in the near term. And even once borders reopen, a survey of travel industry executives suggests that domestic and short-haul travel in Asia Pacific will recover faster than long-haul travel (exhibit 2).

**Exhibit 2: Hotel Recovery Likely to be Led by Short-Haul Travel**




Sources: PATA, Economist, Collinson/CAPA, PGIM Real Estate. As of September 2021.

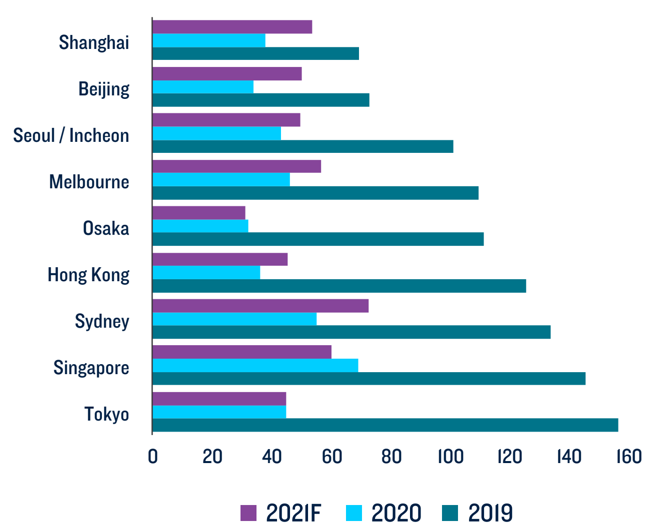
Hotel performance will largely mirror the recovery of the tourism sector. We expect markets with strong domestic bases to recover generally faster, although individual market nuances will matter too. Take the difference in recovery paces between the China and Japan and Australia markets as an example. All of those markets benefit from large domestic-tourism sectors, but although hotel RevPARs (revenues per available room) in Beijing and Shanghai are forecast to recover to pre-pandemic levels in the second half of 2021, hotel RevPARs in Tokyo and Sydney are expected to remain at 55% and 30% below pre-pandemic levels, respectively, by year-end (exhibit 3). Lower vaccination rates and new waves of COVID-19 infections in Japan and Australia are clearly major factors in delays of relaxations of mobility restrictions and the recovery of domestic travel.

Hotel fundamentals and recovery trends are likely to remain varied in the near term, but hotel asset valuations have been more stable and resilient across the region. Variations in asset values for selected portfolios in Singapore, Australia and Japan indicated declines in the range of 5 to 15% in 2020 (exhibit 3)—a relatively modest fall compared with room rates and occupancies that dropped well over 50%. This comes as independent valuers maintain their positive longer-term views on the sector, indicating expectations of a full recovery in the medium term.

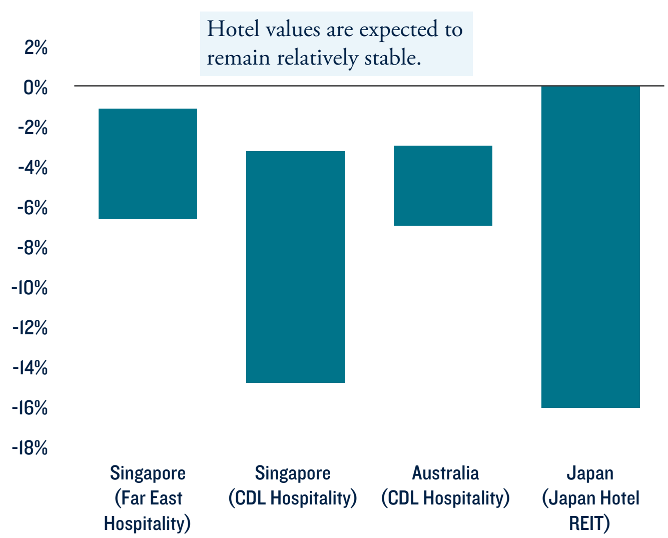
The resilience in hotel valuations is aligned with evidence from transactions with generally no apparent trends of distress or substantial pricing discounts. Hotel capital values have been supported by a number of factors, including strong capital inflows to real estate, low current borrowing costs, lenders' general willingness to refinance loans and governments general willingness to make generous fiscal handouts to the travel and hospitality sectors. The generally low transaction volumes partially reflect a lack of available stock for sales. Pricing discounts will likely remain opportunistic for investors seeking to enter the sector.

**Exhibit 3 : Hotel Pricing Has Been More Resilient Than Performance**

**Hotel Revenue Per Available Room** (US$)




**Hotel Portfolio Valuations 2020 vs. 2019** (Selected Portfolios)




Sources: HVS, Company Reports, PGIM Real Estate. As of September 2021.

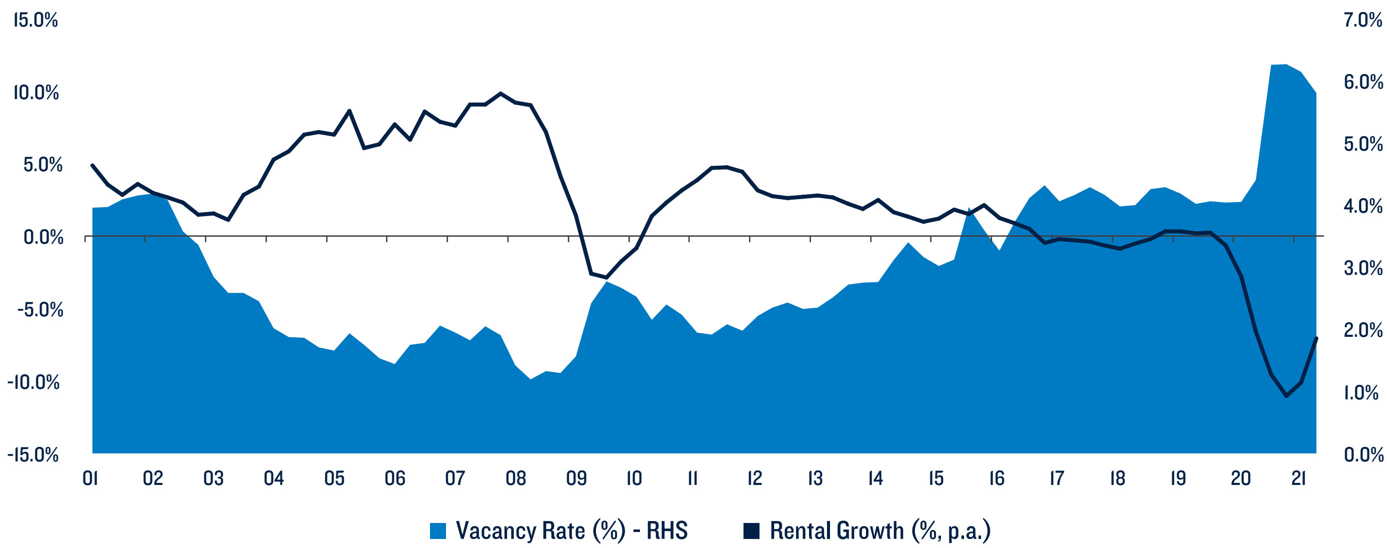
## In the Hunt for Yield, Will Capital Start (Re)Turning to Retail?

Besides hotel, retail is another sector hard-hit by the pandemic. For a large part of the past 18 months, shopping malls and retail stores across Asia Pacific have been struggling to cope with lockdowns and periods of tighter social distancing measures as governments respond to new waves of COVID-19 infections. At its worst, average Asia Pacific retail and recreational activity fell nearly 60%, with cities under lockdown seeing mobility declined by as much as 90% compared with pre-pandemic levels.

Restrictions on consumers' mobility have served as catalysts for the surge of online shopping, but they also mean that retailers and retail malls have had to operate in arguably the most challenging environment in history. Despite governments' support packages and economic relief that targets the hard-hit sector, vacancy rates have risen across all retail segments. At the end of 2020, the average retail vacancy rate was 6.3%—the highest rate ever recorded across Asia Pacific and more than double the vacancy rate of 2.8% at the peak of the global financial crisis (exhibit 4).

**Exhibit 4: Retail Has Been Hit Hard by the Pandemic**

**Asia Pacific Prime & Regional Shopping Malls** (Rental Growth (%, p.a.) and Vacancy Rate (%))




Sources: JLL, PGIM Real Estate. As of September 2021.

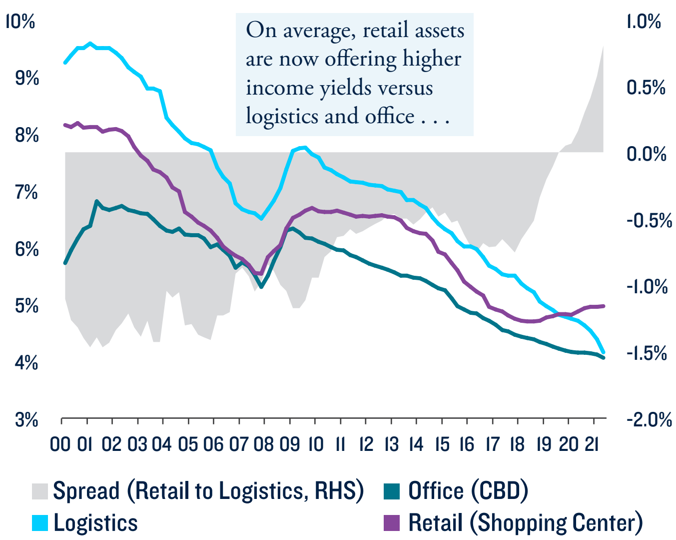
Despite the intermittent social-distancing policies, economic conditions have been recovering in all major developed economies, thanks to stronger exports and resilient domestic demand. Economic growth forecasts are expected to see generally solid growth averaging 6.5% in 2021 for the Asia Pacific region. Australia, Hong Kong, Singapore and South Korea are seeing particularly strong recoveries.

Benefiting from a stabler economic environment and an improved outlook, the retail sector is showing signs of recovery. Vacancy rates have started to fall, and rental declines are slowing (exhibit 5), though the improvement remains fragmented and varied across markets and retail segments. For instance, neighborhood stores and retail warehouses are doing noticeably better than prime shopping malls and high street shops are.

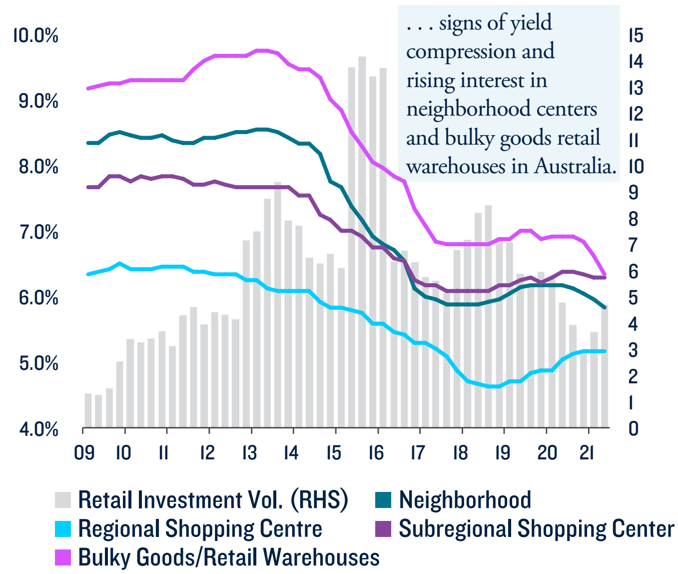
The case for an improving investment proposition for retail is evident from a pricing perspective. Facing structural headwinds from the rise of e-commerce—a trend that has accelerated during the pandemic—the retail sector has seen asset yields expand in the past few years. This is in contrast to office and particularly, logistics yields, which have continued to compress during the same period. Strong capital inflows and competition for logistics assets have turned the yield premium that retail assets used to have against logistics warehouses to a yield discount (exhibit 5). For income-seeking investors, this indicates that the cash flow and income streams generated from retail assets are now cheaper, on average, than those from logistics.

**Exhibit 5: Retail Assets Now Offer Wide Yield Spreads Over Other Real Estate Types**

**APAC Real Estate Sector Yields**




**Australia Retail Yields by Segments and Investment Volumes (US$ Bln)**




Sources: RCA, JLL, PGIM Real Estate. As of September 2021.

Notwithstanding that, uncertainties remain for retail. A range of factors—from the secular rise of online shopping penetration to shifts in consumer behavior, to potentially long-lasting impacts from social distancing measures—is resulting in structurally lower demand for retail space. At the same time, the retail sector is also evolving, and there is growing evidence that performance will be diverse among retail asset types. Necessity retail, including neighborhood shops, continues to prove its resilience, and retail warehouses can offer repositioning opportunities to take advantage of the rise of omnichannel sales of bulky goods.

It is still early to call a recovery for retail, but the combination of a stabilizing outlook for occupancy and rents and an attractive yield spread of retail assets over other commercial real estate types could soon draw investors' attention back to retail. Taking the Australian market as an example, transaction volume of retail assets has indeed been recovering, and yields of retail warehouses and neighborhood shops have compressed since the beginning of 2021.

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