BlackRock.

Real Assets Viewpoint

July 2020

COVID-19: Finding Nemo and Dory

Navigating a brave new world, from the comfort of your home

Amid the deep strains of **a global pandemic and recession**, there are clearer signs of divergence emerging across markets. While the virus runs unchecked in some parts, there are steadily more indications that the APAC markets are mostly past **the pandemic's peak** and **the economy's trough**.

For investors, this is the prime time to be **preparing your strategy** and **readying your capital**. In this new world, should investors focus on finding 'Nemo' (new era market opportunities) or finding 'Dory' (dependable occupancy, rents and yields)? More specifically, how does this seismic shift inform our regional and sectoral strategies and the best entry price points?

Reviewing the APAC investment thesis: what stays, what goes?

The last six months were interesting. Certainly, the first half of 2020 has been relatively eventful, with bushfires, typhoons, a pandemic, geo-politics and social unrest all adding to market uncertainty and a global recession. These events will deeply alter the investment landscape for years ahead.

A gap semester or a gap year? While the coronavirus outbreak continues in many parts of the world, there are more tentative signs of containment within Asia, albeit with smaller sporadic outbreaks. In the second half of 2020, we expect economic and real estate market recoveries to diverge significantly.

Tracking each turning point. While we may have seen the APAC turning tides in coronavirus cases, lockdown restrictions and economic activity, the adjustment in real asset prices may take much more time to realise. This is the best time to ready your capital to take advantage of the next upswing.

A strengthening investment thesis. Moderate APAC demand growth stands out starkly in a low-growth world. Asset prices, yields and spreads over funding costs are all improving, even as we move into the next upswing. Competition for assets is thinner, as some contend with legacy exposures.

Finding Nemo. What are the new era market opportunities? Many business models are being reconfigured, requiring specialist skills and new capital. The move back home continues, supporting logistics, data centres, digital upgrades and lower density usage, with big impacts on portfolio allocations.

Finding Dory. Where are the dependable occupants, rents and yields? The cyclical downturn is improving pricing by the day. There are considerable opportunities ahead, especially where there are resilient income streams, but some segments of retail and hospitality may never make a full recovery.

The price is right. All these strategies – new or old – work at the right price, although entry prices may differ markedly by region and sector. Amid a downturn, pricing is uncertain and moving every day. How do we assess what the right entry price might be for each market… when does that time come?

I'm a model, you know what I mean? With few transactions and limited price discovery, we apply econometric models to provide some guidance on the likely extent of yield softening and price correction, with estimates that are consistent with the observed size of the economic cycle. We corroborate this with on-the-ground market intelligence from in-house deal sourcing teams.

Figure 1: Real estate prices are falling more broadly, albeit at differing speeds

Capital values *(quarterly change)*	2020 Q1	2020 Q2
Office		
Hong Kong	-7%	-8%
Shanghai (D/C)	-6%	-4%
Shanghai (Puxi)	-1%	-2%
Singapore	flat	flat
Tokyo	+2%	-1%
Chatswood	flat	+1%
Sydney	+2%	+1%
Adelaide	+8%	flat
Retail		
Hong Kong	-10%	-12%
Singapore	flat	-7%
Sydney (regional)	flat	-6%
Shanghai	-1%	-4%
Sydney (LFR)	-2%	flat
Industrial		
Hong Kong	-1%	-5%
Tokyo	+1%	flat
Shanghai	+1%	+1%
Singapore	+2%	flat
Sydney (OCW)	+2%	+1%

Source: Jones Lang LaSalle Real Estate Intelligence Service, BlackRock (July 2020). In local currency. D/C = decentralised; LFR = large format retail. OCW = Outer Central West. There are no published series for LFR values, so these estimates are inferred from reported specialty rental growth and cap rate change. ***Past performance is not a reliable indicator of current or future results.***

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A case of viral and lockdown fatigue

The global pandemic continues...

More than six months into a once-in-a-century global pandemic, there are still **concerning signs of ongoing infection** on a widespread basis. As of 24 July 2020, confirmed cases exceed 15 million globally, while active cases are still doubling every 50 days, but with a very skewed geographical pattern. Indeed, we see **considerable variations between regions**, as some locations see a rapidly expanding outbreak, while other locations report a more sustained recovery, albeit with a very cautious eye on potential reinfection. Across the key APAC markets, there is a wider pattern of recovery, as many regions **move past their local peaks for cases.** The subsequent recovery trend has been very uneven, however, with numerous (but relatively smaller) secondary outbreak clusters. (Source: Johns Hopkins University, July 2020)

...but the APAC recovery is still on track

Since the peak, we are seeing slow and cautious moves **towards a relatively normal life**, as activity restarts and schools return. There are some retracements, as a few cities drift in and out of lockdown. Other aspects of normality are still in the works, as cross-border travel remains seriously curtailed, being held back partly by stringent quarantine measures on arrival.

A cautious eye on new infections...

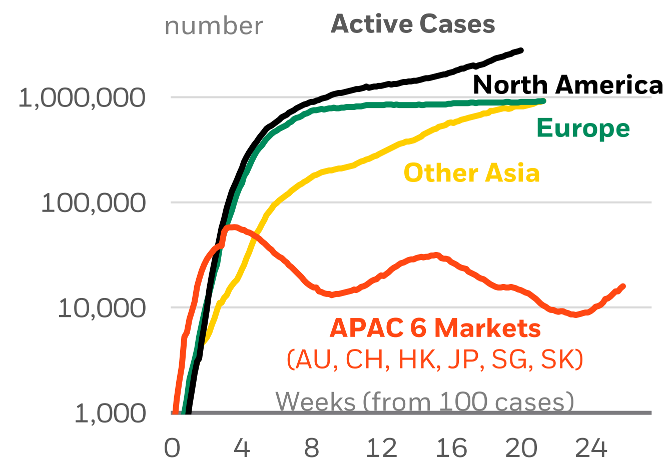
Second-wave infections remain a persistent risk. More recent outbreaks highlight specific vulnerabilities, namely worker dormitories in Singapore, churches/nightclubs in Seoul, food markets in Beijing, public housing in Melbourne and aged care homes in Hong Kong. As local cases rise again, Melbourne returns to a six-week lockdown and Hong Kong reinstates social distancing measures. In Beijing, an outbreak of 300+ cases prompted an urgent and comprehensive response, including a localised lockdown of 500,000 people and 100,000 tests per day. This outbreak was largely contained in a week. (Source: China Global Television Network, July 2020)

...with quick responses...

With each new cluster, there is an acute reminder to maintain newly learnt social distancing habits. With each successful containment effort, public health officials become a little bit more practiced with mounting **timely and effective responses** to contain these secondary outbreaks, with localised lockdowns, widespread testing, aggressive contact tracing and steadily rising stores of medical and protective equipment. Moreover, the newly established **health infrastructure** remains well set in place and ready on high alert, notwithstanding fewer cases across much of this region. This circular pattern of outbreak, response and containment may likely be **the default course for the foreseeable future**, at least until we have a safe and reliable vaccine for deployment.

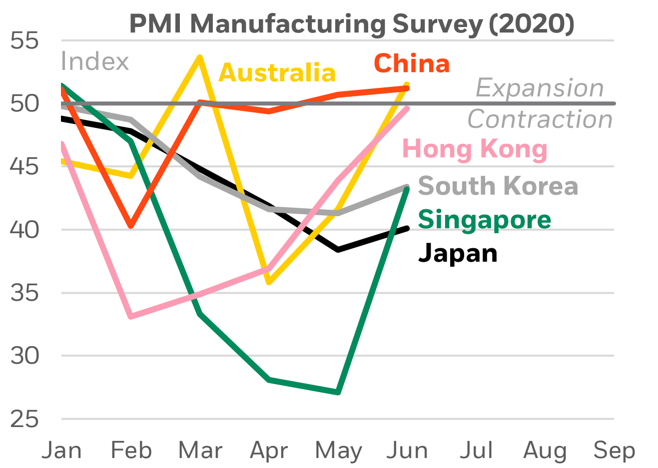
...and better infrastructure

Figure 2: Despite renewed outbreaks, APAC cases are trending lower, past the local pandemic's peak



Source: Johns Hopkins University, BlackRock (24 July 2020)

Figure 3: APAC indicators lift more broadly as the regional economy moves past its cyclical trough



Source: Bloomberg, BlackRock (July 2020)

Reassessing the APAC investment thesis

What has changed?

In the context of lower coronavirus case numbers, improving economic activity, but ongoing market pricing adjustment, it is a very opportune time to revisit the APAC real assets investment thesis, particularly to see **what is changing** and **what is still the same** in this new market environment.

Growth drivers are slower but well intact…

At a macroeconomic level, **the structural growth dynamics** for the APAC region – robust population growth, rising productivity and improving incomes – are still very much intact. Certainly, there are some common elements with the global outlook, with a deep pandemic-related disruption and a potential subsequent recovery. At the same time, there will likely be **significant regional differences ahead**, given dramatically different degrees of progress in terms of viral containment and as some cities drift in and out of activity lockdown.

…and looks firmer on a relative basis

On a relative level, the APAC region is becoming **more important as a global growth driver**, even with uniform downgrades for 2020. The revised APAC growth outlook is still substantial (2020-24: 3.8% p.a.), especially compared to the US (1.4% p.a.) or the Eurozone (0.9% p.a.). (Source: Oxford Economics, July 2020) In other words, current APAC growth expectations are 2½ times that of the US and 4½ times that of the eurozone. This region is expected to deliver around half of the world's demand growth over the next five years, given diminishing contributions from other parts of the global economy.

This **persistent growth gap** has profound implications for expected returns. Firmer growth has historically been strongly correlated to occupancy demand growth, rental income growth and total returns. This correlation applies broadly at a pan-regional level, but also narrowly at a city-specific level.

Pricing is improving…

In a global downturn, **asset prices are moving down** more broadly and more clearly. What was an expensive market in 2019 is showing greater value in mid-2020, with further adjustments expected. Additionally, lower interest rates are reducing funding costs, widening the yield spread for investors.

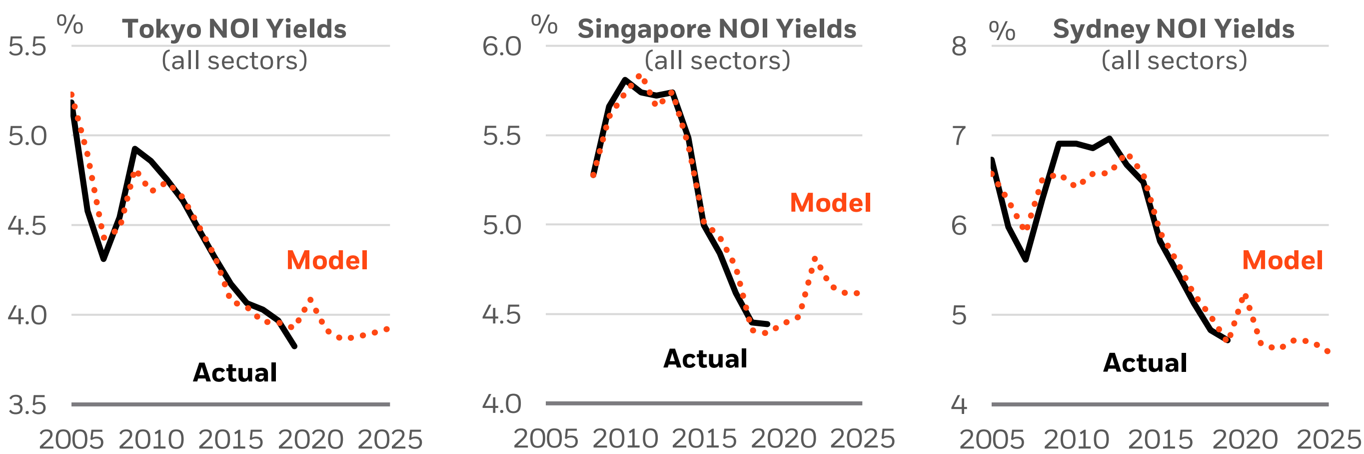
…but it is hard to be precise…

This **pricing adjustment is prolonged** by several factors, namely a wide bid-ask spread, distressed vendors in denial and progressively less-forbearing banks. Additionally, in the absence of market trading activity, there are not enough comparable sales to provide adequate pricing discovery.

…but models may inform…

In this context, it may be useful to apply simple econometric models to **illustrate likely adjustment paths** for yields and pricing, given the historical linkages between asset prices and economic / financial indicators. This is a partial signal, used in conjunction with on-the-ground intelligence reports.

Figures 4 to 6: Modelling analysis suggests that yields are set for a near-term softening with the slower economy, before a subsequent firming with the expected activity rebound, aided by low interest rates



Source: BlackRock Real Assets (July 2020). Model estimates prepared by BlackRock Real Assets using inputs from Bloomberg, MSCI IPD and Oxford Economics. ***Past performance is not a reliable indicator of current or future results. Forecasts made may not come to pass.***

…potential adjustment paths

The modelling insights are two-fold. Firstly, we can readily **explain historical yield movements** using a parsimonious set of drivers, including economic growth, inflation, interest rates/yield curves and momentum. Secondly, using forward estimates of these indicators – a sharp dip in activity, lower interest rates – we can get a sense of **the potential magnitude of the yield shift** ahead. Certainly, models are never perfect and economic projections may change over time, but this framework allows for a more informed discussion about the likely extent and timing of these pricing adjustments. In this context, **sensitivity analysis** of key inputs and **live corroboration** from on-the-ground sourcing teams will also be critical factors in setting these pricing guideposts.

Fishing for opportunities across APAC real estate

Structural winners

Cyclical resilience

These broad market trends will likely play out as **highly differentiated cyclical adjustments** for each city and market sector. Already, there are clear divergent trends for COVID cases (figure 2), economic indicators (figure 3) and pricing adjustments (figure 1), which we would expect to drive market adjustment paths (figures 4-6). We also consider the potential impacts across sectors both near- and longer-term (figure 7). At a sectoral level, should the focus be on **structural change** (new era market opportunities), **cyclical resilience** (dependable occupancy, rents and yields)? The short answer is likely both.

Office outlook is mixed…

…as usage and locations change

For **office**, the sudden shift to work from home may take time to unwind, and perhaps never fully do so. A demand reduction is clear in 2020, but is more ambiguous beyond 2021. While **employees** anecdotally report better work-life balance and 'workplace' productivity, the latter claim is not tested empirically (kids, what do you want now?). For **employers**, the cost calculus is not always straightforward either, as the prospect of lower rental outlays may be offset by increased costs for home fitouts, questions over insurance coverage, diminished supervisory control and uncertain effects on productivity. **Usage patterns** may change from here, as we migrate from dense, static fitouts to sparser, multi-functional hubs, a move that may take some time, considerable refurbishment expertise and value-add capital. Similarly, **locational choice** may also evolve, as commuting becomes less desirable (particularly in cities with older, less-ventilated transit systems or expensive parking), which may prompt a shift from city centres to the city mid-ring. All this can potentially constrain rental growth, especially in expensive trophy CBD locations.

For **retail**, the structural headwinds are strengthening, not least with the recessionary pull-back in near-term spending. Also, periodic returns to lockdown (as we see in Beijing and Melbourne) are somewhat disruptive to the

Figure 7: The post-COVID environment may see considerable changes in social and economic behaviours, impacting various types of real estate demand, both now and into the foreseeable future

COVID-19 APAC sector impacts	Transaction volumes 2019 share	1H 20 $US b	1H 20 % ch	Demand outlook Short (1 year)	Medium (2 years)	Long (5 years)	Critical demand drivers: What are the key themes impacting on real estate demand in each market segment?
Office	**53%**	**136**	**-27%**				
CBD	35%	94	-26%	↓	↓	→	✗ work from home ✗ long commutes ✓ lower density
Non-CBD	18%	42	-30%	↓	→	↑	✗ work from home ✓ lower density ✓ infrastructure
Retail	**22%**	**58**	**-30%**				
Shopping malls	16%	39	-39%	↓	↓	↓	✗ e-commerce ✗ tourism impact ✗ alternative usage
Other	6%	19	-4%	↓	→	→	✗ e-commerce ✓ convenience
Industrial	**14%**	**47**	**-5%**				
Warehouse	11%	41	-2%	→	↑	↑	✓ e-commerce ✓ automation ✓ new infrastructure
Flex / Other	3%	6	-21%	→	↑	↑	✓ e-commerce ✓ social distance ✓ alternative usage
Hospitality	**8%**	**28**	**-22%**	↓	↓	→	✗ travel restrictions ✗ social distance ✓ quarantine
Multifamily	**3%**	**16**	**+56%**	→	→	→	✓ income resilience ✓ rent vs. buy ✗ unemployment
Student Housing	--	--	--	↓	↓	→	✗ travel restrictions ✗ social distance
Data Centres	--	--	--	→	↑	↑	✓ work from home ✓ tele-schooling ✓ tele-medicine

Source: Real Capital Analytics, BlackRock (July 2020). APAC transactions for some sectors are not reported by RCA. Forecasts made may not come to pass

Retail faces big challenges

...as spending patterns shift...

...and site use changes

recovery, particularly for low-margin retail segments highly reliant on steady incomes. Indeed, **unsteady sales revenues** may tip more retail categories into a downward spiral, as foot traffic diminishes, insurers withdraw trade credit protection, inventory range narrows or social distancing requirements increase, all leading to further erosion of profitability. Some **at-risk categories** include department stores, restaurants, cinemas, gyms, salons and tourist-related entertainment. It is not one-way traffic, as some segments see **a boom in trade** selling groceries, pharmaceuticals and home office equipment. There is likely to be a **locational shift** towards the home as well, as shoppers prioritise safety and convenience. Some landlords may change to larger formats to include more space, drive-thru pick-up and last-mile delivery, all of which are **sensible changes in use**, but at lower-than-before rents.

Industrial is rising with shoppers...

...robots, vegetables and distant chefs

For **industrial**, the much-touted e-commerce tailwind is very beneficial, but not as uniformly as one expects. For now, traditional retailers still take up a significant share of warehouse space, which may slowly be decanted for fast-growing **pureplay logistics providers**. With a demand boom comes a lot of new supply and finding the right undersupplied submarket remains crucial. Meanwhile, the new **bio-security drive** may create more innovative types of traditional warehouse usage, including hydroponic farms (full of vegetables), dark warehouses (full of robots) and dark kitchens (free of diners).

Hotels are the hardest hit

Multifamily holds up

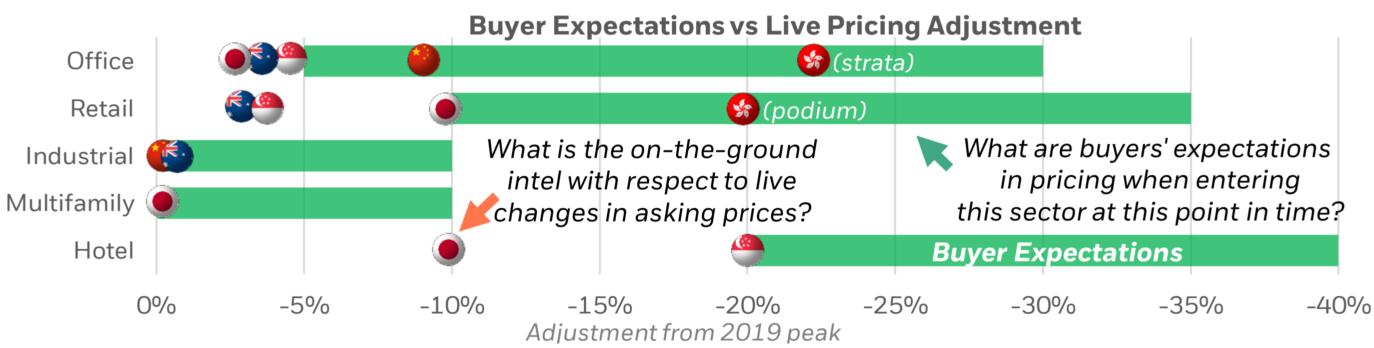
For **hospitality**, persisting travel restrictions continue to weigh heavily on occupancy, even with some supplementary incomes from repurposed usage as a quarantine facility. Distress in this sector is mounting, with no imminent turning point in sight. For **multifamily**, the sector retains its defensive credentials with resilient incomes. Demand is holding, supported by increased propensity to rent (rather than buy), particularly in a struggling labour market. For **data centres**, there is continuing growth in demand, under the increased loads of working, schooling and entertaining at home.

Finding the right entry price, one market at a time

What works at what price?

Given these differentiated market adjustments, it is important to note that this is not a simple list of do's and don'ts, but rather a measure of **relative price expectations**, particularly in a less-liquid, swift-moving market. Indeed, even the most challenging market may work at the right price, although a more attractive entry window would be required. In this context, what is a **compelling entry window** (expressed against 2019 asking prices)? Which sector or which region warrants a higher threshold? What is the real-time adjustment in price we should look to realise in sourcing potential pipeline assets (in impaired assets, as opposed to well-stabilised yielding assets)?

Figure 8: While well-stabilised assets are holding their value, others come quietly to the market with impairments and discounts. What is the appropriate discount window for entry in this market cycle?



Source: BlackRock Real Assets (July 2020). Reported discounts are based upon anecdotal reports from local investment sourcing teams, given current market discussions of potential movements in asking prices, rather than any closed transactions that take much longer to realise. ***Past performance is not a reliable indicator of current or future results.***

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