Are rising yields a concern for Asian REITs?

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We believe that Asian REITs will continue to perform well while the economic recovery in Asia and the rest of the world remains strong and as long as the rise in bond yields do not become excessive. Despite some short-term challenges, long-term prospects for Asian REITs are favourable and the benefits of investing in the asset class remain firmly intact, in our view.

By Eric Khaw, Senior Portfolio Manager

Economic recovery optimism outweighs inflation fears

The global economy has picked up steam on the back of extensive fiscal stimulus and ultra-accommodative monetary easing measures, leading to fears of a continuous spike in inflation. Inflation concerns, in addition to optimism towards a global economic recovery, have in turn triggered a surge in global bond yields and weighed on an array of income-producing assets.

But in a display of resilience, Asian real estate investment trusts (REITs), while experiencing some profit taking in February, have managed to hold on to gains* so far this year (as at end-April 2021), as continued optimism about a vaccine-led regional economic recovery has outweighed persistent concerns towards inflation and rising bond yields.

Notwithstanding an upswing in bond yields and a pickup in global inflation, we believe the outlook for Asian REITs remains bright as many countries in the region continue to experience robust economic recoveries from pandemic-induced recessions.

The recovery by regional economies has been gaining momentum, and that is seen generating higher income and new revenue opportunities for Asian REITs. As long as the rise in bond yields is not too excessive and economic growth in Asia and the rest of the world remains strong, we expect regional REITs to continue performing well.

Differentiating the reasons for the rise in bond yields

There is little doubt that a strong and continuous pick up in bond yields will limit the upside for REITs in general as higher long-term interest rates reduce the present value of future dividends and hurt the valuations of these income-producing assets. This is generally the case when higher bond yields are the result of aggressive interest rate hikes by central banks trying to tame runaway inflation in overheating economies. Aggressive tightening of monetary policies often leads to a slowdown of the overall economy. And weaker economic growth will negatively impact retail and corporate spending, stall or impede the growth of office and commercial rental space and reduce the overall demand for real estate—all of which will hit the earnings and income stream of REITs.

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* Regional REITs, as measured by the FTSE EPRA Nareit Asia ex Japan REITs 10% Capped Index, were up nearly 3% in Singapore dollar terms on a year-to-date basis, as at 30 April 2021.

To be sure, there is a risk of inflation picking up globally as economic growth normalises. China, the first major economy to rebound from coronavirus-induced recession, has already seen some gradual monetary policy tightening by its central bank. Tightening of liquidity in a global scale could take place if Western central banks, such as the US Federal Reserve, start to taper quantitative easing and eventually end their ultra-loose monetary policies.

Such a scenario, however, is not in play at the moment. Nor is such a scenario likely to unfold in the near future, as many economies are still at the early stages of recovery after being hit hard by COVID-19 in 2020. As we see it, the recent rise in bond yields is merely a function of the markets pricing in a higher level of global economic growth from a very low base and an inevitable pick-up in global consumer prices from the deflationary levels of 2020. We therefore do not expect an excessive rise in bond yields over the next 12 to 24 months. Asian REITs should be supported if yields climb moderately amid a period of steady economic recovery to pre-COVID-19 levels.

During an economic recovery phase, when corporate profitability increases and consumer spending rises, the income stream for REITs will likewise start to improve as rental growth normalises. Such a backdrop, even if it creates some inflationary pressures and causes long-dated bond yields to rise, will be positive for regional REITs, in our view.

Outlook for Asian REITs

Despite short-term headwinds, medium to long term outlook for regional REITs remains positive

Despite short-term headwinds from rising yields and the resurgence of COVID-19 infections in parts of Asia, the outlook for regional REITs over the medium to long term remains positive.

Long-term drivers such as ongoing structural reform in the region, signs of a shift in global growth leadership from the US to Asia and the emergence of new real estate segments with structural growth, including data centres and e-commerce logistic facilities, should continue to support revenue growth and enhance fundamentals in Asian REITs.

We continue to be sanguine on regional REITs with long-term structural growth, especially in the areas of e-commerce, logistics and data centres, all of which appear to support long-term investments. However, these assets are also looking relatively expensive recently as a significant part of the positives have been priced in. In the short term, due to valuation reasons we have turned slightly cautious and selective towards REITs with assets related to e-commerce and data centres. Nonetheless, we still have a favourable view towards these REITs, which have good growth prospects on a long-term basis.

Retail, office REITs expected to recover steadily

Retail is another REIT subsector that is recovering well after being hit hard by the pandemic in 2020. Sales in some suburban malls in Singapore, for instance, have returned to pre-COVID-19 levels. As long as the sales are there, rental earnings should hold firm for many retail REITs. After dismal earnings in 2020, we could see some decent growth in 2021 from many regional retail REITs, which appear to have their worst phase behind them.

After retail, we expect office REITs to be the next group to recover. Teleworking may be the default work setting in many Western countries, but the dynamic here in Asia is different. Homes in Asia are relatively smaller compared to those in the West. The average apartment size in Hong Kong, for example, is about 500 to 600 square feet, forcing many residents to telework in a very small space. That was why more than half of the work force in Hong Kong still showed up at their offices at the height of the pandemic in 2020, with many Hong Kong residents seen to actually prefer working in the office. Also considered to be playing a role is Asia's "face-time" culture, in which bosses value physical presence and therefore want to see their employees in the offices.

In countries such as India and the Philippines, inadequate infrastructure has made teleworking difficult. All in all, office REITs in Asia are still seeing decent rental income despite the ongoing pandemic. In Singapore, where the supply of office space is expected to remain tight over the next three to four years, we expect office REITs to be very resilient, supported by a booming technology (tech) sector. Many big tech companies are setting up their Asian headquarters in Singapore, and these initiatives are the driving demand for office space in the city state.

As mass vaccinations gather pace in the region and allows countries to lift lockdown measures, we expect Asian REIT subsectors such as retail, office and hospitality to benefit from the re-openings of economies, borders and

businesses. Prospects could also be brighter for industrial REITs thanks to significant improvements in the region's manufacturing sector.

Hong Kong a sweet spot

In terms of countries and regions, we think Hong Kong is currently a sweet spot. Valuations in Hong Kong are at an all-time low, and REITs there are yet to price in a re-opening of the economy. Apart from the disruptions caused by COVID-19, Hong Kong has also experienced periods of political instability over the past two-and-half years. The newly legislated national security laws in Hong Kong may have made it more appealing to Chinese mainlanders who shop and conduct business in the special administrative region. With the development of the Guangdong-Hong Kong-Macau Greater Bay Area (GBA), which covers about 56,000 square kilometres, Hong Kong could become a very relevant anchor city. The development of the GBA is expected to be positive for real estate in Hong Kong over the longer term. In addition, the territory's position as a financial hub and gateway to China continues to give Hong Kong office REITs an edge. We therefore expect Hong Kong REITs to do well, potentially becoming one of the biggest beneficiaries when the border between China and Hong Kong is re-opened.

Outlook for Indian REITs

Despite the short-term challenges India is currently facing amid a major wave of COVID-19 infections, the long-term outlook for Indian REITs remains positive, in our view. India is going through an exciting period of reforms and its economy could take off in a big way over the next decade or two. Indian REITs are exposed to the forefront of reforms, especially in the areas of logistics, industrials and office parks, all of which are driven by tech demand. E-commerce in India is also starting to take off. On top of that, the Indian real estate market is consolidating; the emergence of big developers is allowing these dominant players to convert prime real estate assets into REITs. That could evolve into a strong structural trend, leading to listings of significantly more Indian REITs over the next decade.

Cautious on hotel REITs

Within Asian REITs, we are cautious towards sectors linked to hotels, both in the short and medium term, because their recovery could take longer than many expect. In addition, business culture is undergoing a structural change. In the post-COVID-19 world, business travel may require a long time before recovering to pre-pandemic levels due to the emergence of Zoom and other internet-based meeting apps. Virtual business meetings will not go away, in our view, even if many aspects of everyday life return to normal. We therefore believe that hotel REITs will continue to face reductions in income if demand for business travel does not immediately recover.

Total returns are still attractive; long-term positives remain intact

The total return aspect (regular income, as measured by the distribution per unit, plus potential capital gains) remains the most attractive feature of Asian REITs.

Even though bond yields are rising, total returns from regional REITs, which exceeded more than 10% as at end April 2021, still look relatively appealing versus those of bonds and many other income-generating securities. For example, the yield spread between the average distribution per unit (DPU) of Singapore REITs and the 10-year Singapore government bond yield is generally in excess of 250 basis points.

In addition, REITs in the region could continue to take advantage of relatively low borrowing costs and engage in accretive property acquisitions, which are the purchases of assets that results in an increase in the DPU of the acquiring REIT.

Moreover, the long-term attractiveness of regional REITs remains intact. Asian REITs continue to be one of the fastest growing asset classes in the region, expanding in terms of depth and breadth. They also have a relatively low correlation with global REITs, providing investors with diversification benefits.

All in all, we believe that Asian REITs—offering decent yields, a sustainable income stream and exposure to the region's biggest landlords—remain an attractive asset class for long-term investors. In the short term, as mass vaccinations against COVID-19 get underway in Asia, we expect regional REITs to benefit from the re-openings of economies, borders and businesses.

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