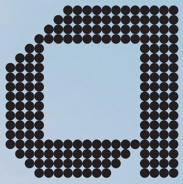

Asia-Pacific Real Estate Market Outlook

Q1 2023

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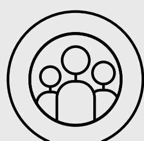
“While our global recession call is now shared by many observers, we think the market may still be underestimating the potential depth and severity of the downturn.”

Executive summary



- Our view remains that aggressive monetary tightening, a large energy price and terms of trade shock in the UK and Europe as well as China’s broad-based economic challenges will combine to push the global economy into recession in 2023. While our global recession call is now shared by many observers, we think the market may still be underestimating the potential severity of the downturn. As well, the large interest rate cutting cycle that we think will follow is not yet priced into markets. While the Chinese government has rapidly moved away from its “zero-Covid” policy, we expect a bumpy transition towards endemic living. In Japan, notwithstanding the surprise from the BOJ in late-December, we do not think meaningfully tighter monetary policy is on the horizon.
- While 2022 was a challenging year for real estate investment returns on account of the rapid rise in borrowing costs, we think returns could deteriorate further in 2023 as the decline in capital values looks set to accelerate. We expect this to be led by offices, especially those in HK, Australia and China. In the case of China, we expect the easing of Covid restrictions to allow more due diligence to take place, which should in turn translate into more transactional evidence to support a faster mark-down to market. On a more upbeat note, institutional investors’ interest in APAC commercial real estate remains high, which should provide the foundation for an eventual recovery beyond the immediate term when interest rates could be trending lower.
- Seoul and Singapore offices as well as industrial/logistics properties in Australia and Korea could present investors with attractive capital deployment opportunities in 2023. Per JLL’s data, market yields of these sectors have risen more than their peers so far while their rent growth prospects remain solid, in our view. We continue to think that an opportunistic strategy, in general, may work better for real estate investors heading into an economic downturn (vs. value-add) while debt strategies are also well-positioned to generate attractive risk-adjusted returns given rising rates and better protection of capital in the near term. Finally, we reiterate our view that the bifurcation in performance between higher spec and lower grade offices will continue and creative interventions to future-proof assets should yield above-average returns.
- Unlike the experience in most markets in 2022, investors’ expected cap rates for Japanese commercial real estate were in fact trending lower in most cases during the year. While we do not think the BOJ’s late-December surprise was a signal that meaningfully tighter monetary policy is on the horizon, we think, on balance, the risks for Japanese yields are likely skewed to the upside. Yield gaps are mostly below their long-term averages, which suggests valuation is rich relative to trading history, especially if we were to consider the near-term rent growth outlook could be weaker than what it was historically. On a more constructive note, we expect any increase in yields to be marginal and Japanese real estate’s attractive risk-adjusted cash-on-cash yields to be intact.

Economic Outlook

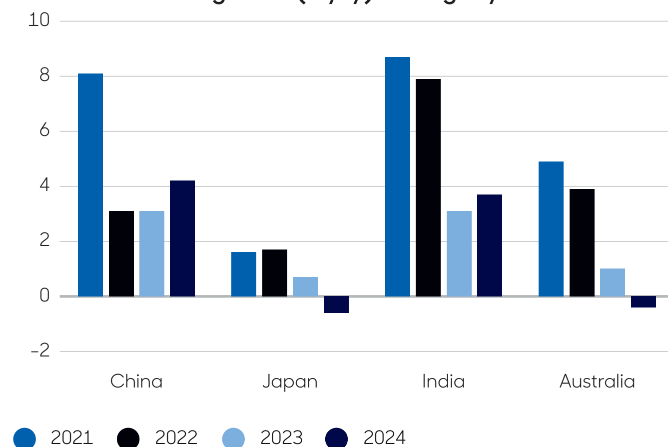
- **Global outlook: on the precipice of recession**
  It remains our view that aggressive monetary tightening led by the US Fed, a large energy price and terms of trade shock in the UK and Europe as well as the broad-based challenges in the Chinese economy will combine to push the global economy into recession in 2023. While our global recession call is now shared by many observers, we think the market may still be underestimating the potential depth and severity of the downturn. As well, the large interest rate cutting cycle that we think will follow is not yet priced into markets. Global headline inflation pressures either have already passed, or are very close to passing, their peak but core inflation will prove much stickier on account of tight labour markets. This suggests taming core inflation pressures will require more rate hikes in the near term to substantially weaken the labour market and push up unemployment rate, which is consistent with a recession. In China, while the government has rapidly moved away from its “zero-Covid” policy, we expect the transition towards endemic living to be a bumpy one. Similarly, policy steps to support the property sector are welcomed but are unlikely to be enough to drive a forceful recovery, in our view.
- **Monetary policies: back to the lower bound by late-2024**
  We envisage more rate hikes across developed markets in the near term, with the risks to the upside if US economic activity were to hold up better than expected. From late-2023, following demand destruction during the anticipated recession that should ultimately put downward pressure on core inflation, we see most

central banks returning to rate-cutting mode. Indeed, we think the speed and extent of these eventual rate cuts could be underestimated by the market. Our forecasts suggest US interest rates could return to the effective lower bound by late-2024. In China, we think policy is on track to be eased further and that should offer some shelter for its nearest trading partners when the global downturn unfolds. That being said, China is highly unlikely to launch a stimulus that matches the CNY4trn package launched post-GFC. As well, its desire to press ahead with its de-risking campaign suggests it will provide only a partial offset to the shock emanating from developed markets. In Japan, the BOJ surprised the markets by expanding its 10-year yield target in late-December but we do not think this is a signal that meaningfully tighter monetary policy is on the horizon, especially given the strengthening headwind against global growth.

- **China: expect a bumpy transition**
  Following the 20 measures announced in mid-November to fine-tune China's "zero-Covid" strategy, Beijing announced a new set of 10 measures to further loosen its Covid policies in early December. While China has rapidly moved away from "zero-Covid", the transition towards endemic living is likely to be a bumpy one. A surge in Covid infections across various Chinese cities has already resulted in lower mobility and business activity, notwithstanding the removal of restrictions, for instance. Further, while broader policy easing is stepping up, investors hoping for a major pivot in the beleaguered property sector are likely to be disappointed. Policy has been struggling to gain traction, in part because monetary easing is ill-suited to counter structural headwinds. Even fiscal policy may be muted given the strain on local government budgets and the central government's desire to de-risk the property sector. China is at least relatively well-placed to withstand the global recession, even if it cannot fully avoid this additional growth shock. It is one of the only major economies without an inflation problem and could therefore unleash policy support without having to wait for imbalances to dissipate first. Overall, we expect China's GDP to fall short of the government's growth target of "above 5%" in 2023.
- **Japan: reopening vs. global headwinds**
  Pent-up demand, following the opening of domestic and international borders, as well as the government's fiscal package announced in October will provide a near-term boost to Japanese activity. However, the global growth backdrop will impact Japan via the trade channel in 2023. Japan is highly sensitive to trade from the US and China and we expect our baseline of a US recession to drag Japan into recession in 2023, with a peak-to-trough decline of roughly 1.5% in real GDP. While headline inflation has surprised to the upside in recent months, we expect inflation pressure to ease in 2023 as energy prices subside and negative commodity price base effects feed into the CPI. The scale of imported price inflation via JPY depreciation should also fade over the course of the year when the Fed pauses amidst a global recession and risk aversion takes hold. This should provide further support for the BOJ to maintain current policy settings at least until the end of Governor's Kuroda's term in March 2023. This is despite the late-December surprise, which was chiefly motivated by functionality issues in the bond market. We see a high likelihood of policy continuity from the new governor, given there is little political pressure to shift.
- **Australia: slower but not done yet**
  While the RBA has slowed the pace of rate hikes since October (to 25bp a month, from 50bp), the central bank has made it very clear that the imbalance between domestic demand and supply needs to be corrected to bring underlying inflation sustainably back within the 2-3% target band. This is especially the case amidst tentative signs of a pick-up in wage growth. It is therefore still our base case that Australia will follow the US into a recession from H2 2023 since it will be hard to push underlying inflation to target consistent levels without a substantial rise in unemployment. While consumer spending has remained solid so far, we see downside risks building as we head into 2023. Apart from a potentially weaker labour market, higher interest rates are also weighing on the housing market – home prices in Sydney, for instance, have already fallen by over 10% so far. Interest costs on mortgages jumped by 36% in Q3 and the constrain on household budgets will likely strengthen further. On the external front, Australia will be vulnerable to the global downturn as both commodity prices and export volumes decline, unless China's recovery turns out to be more robust than what we are currently projecting.

"While 2022 was a challenging year for real estate investment returns, we think returns could deteriorate further in 2023 as the decline in capital values looks set to accelerate."

Chart 1: Real GDP growth (%y-y) among key APAC markets



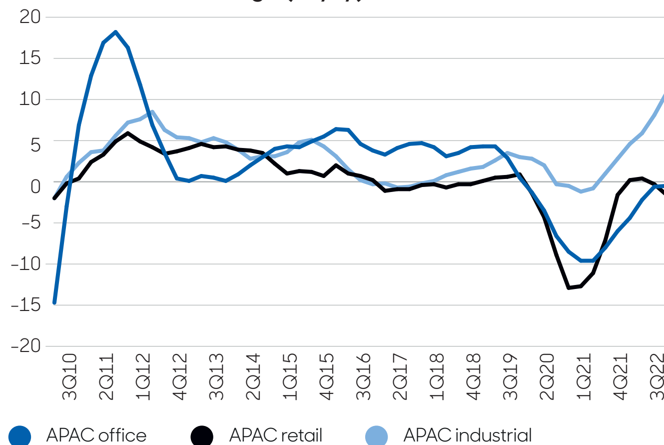
Source: abrdn Research Institute, December 2022.

Real estate occupier trends

- **APAC offices: Seoul's occupier fundamentals showing no signs of softening**
  On average, office rents across key APAC markets fell by 0.5%y-y in Q3 2022 (from -0.6% in Q2; Chart 2) while vacancy rate expanded to 11.2% during the quarter (from 10.9%). HK led the rise in Q3 office vacancy principally on account of new completions in Kowloon East. Meanwhile, Seoul and Singapore remained the two best performing office markets in APAC in Q3, registering an average y-y growth in office rents of 21.4% (from 15% in Q2) and 11.2% (from 9.5%), respectively. In Seoul, the overall office vacancy is now at a low of just 2.5% (from 3.9%), with vacancy in Gangnam now under 0.5% for the third consecutive quarter. With overall stock expected to expand by just 4.6% over the next three years (vs. 14.8% in the past three), we expect office vacancy in Seoul to remain tight. While companies have implemented flexible work arrangements, Seoul's physical office occupancy has been relatively high. Nearly half of unmarried Koreans in their 30-40s live with their parents and the average living space per person is just 34 sq m, per JLL's estimates. As such, most workers prefer to keep their workspace and living space separate, which has contributed to a higher rate of return to offices.
- **APAC retail: Singapore's positive momentum faces stronger headwind in**
  The average y-y decline in prime retail rents across the APAC markets we cover accelerated to 1.6% in Q3 2022 (from 0.3% in Q2) even as most markets continued to reopen post-pandemic. The acceleration in rental decline followed an increase in the average vacancy rate to 7.8% during the quarter (from 7%), led by Chinese Tier-1 cities Beijing (7.2%, from 6.1%) and Shanghai (12.7%, from 9.9%). While the move away from "zero-Covid" is welcomed news for the Chinese retail sector, we expect consumer sentiment and behavior to remain cautious in the face of a potential surge in Covid infections. Moreover, the relaxation in travel restrictions may result in more outbound travel which could be a net negative for the domestic retail market. Outside of China, Singapore's prime retail market was the region's best performer for the second consecutive quarter in Q3, with an average 2.9%y-y gain in rents (from +1%). Leasing demand in Q3 was primarily driven by F&B operators but there were also a few local online fashion and athleisure retailers opening their maiden physical stores. It remains to be seen if the momentum can be sustained heading into 2023 when there could be a global recession and GST will be higher by 1%pt.
- **APAC logistics: occupier fundamentals still solid despite cautious sentiment**
  While investment sentiment towards the logistics sector has turned more cautious since the beginning of 2022, occupier market fundamentals have remained solid. On average, logistics rental y-y growth across APAC's key markets continued to accelerate in Q3 at 10.8% (from 8.1% in Q2), with Australia still firmly in the leadership position (+22.3%, from +14.1%). Looking ahead, while our base case assumes the Australian economy to follow the US into recession from H2 2023, we expect record low vacancy and an overall smaller pipeline of new supply (stock projected to grow by 16.1% over the next three years, vs. +19.4% over the past three) to provide sufficient support for further rental upside. Indeed, JLL has raised its three-year forward rental growth forecast for the key Australian logistics markets to between 3.6%p.a. (Perth) and 7%p.a. (Sydney), from 2.8%p.a. and 6.9%p.a. previously. Apart from Australia, prime logistics rents in Singapore also registered a marked pick-up in y-y growth during the quarter at +9.3% (from +7.8% in Q2), with the average vacancy rate unchanged at 9.1% - the lowest since Q1 2016. Looking ahead, while we see vacancy potentially trending higher from here, we expect rental growth to continue in the near term albeit at a slower pace.
- **Japan multifamily: worst of Tokyo's negative rent reversion likely over**
  While the average y-y rent change within the Tokyo 23 wards was negative again in Q3 after two consecutive quarters of positive change (-0.3%, from +0.6%), per Tokyo Kantei's data, we think the worst of the rental decline is likely over, especially for single-type units. Nippon Accommodations Fund (NAF), one of the larger

Japanese residential REITs by market cap, reported its financial results for the six-month period ending August in Q4 and a key takeaway was the slower rental decline at tenant turnover for the single-type units in its portfolio (-2.4%, from -4%). Importantly, the average difference between the contracted rents and the target rents for the single-type units had narrowed to just -0.2% during the period (from -2.3%), which further suggests the worst of negative rent reversion could be behind us. Meanwhile, the rent change at tenant turnover for apartments in other major Japanese cities turned positive for the first time in two years during the financial period ending August (+0.2%, from -0.9%). Considering apartments in Nagoya represent the biggest share of NAF's assets in other major cities and rents in Nagoya were up 3.2%y-y in Q3 per Kantei, we think the Nagoya assets could have been a key contributor to the improved performance.

Chart 2: Net rent change (% y-y)



Source: Jones Lang LaSalle, abrdn, December 2022.

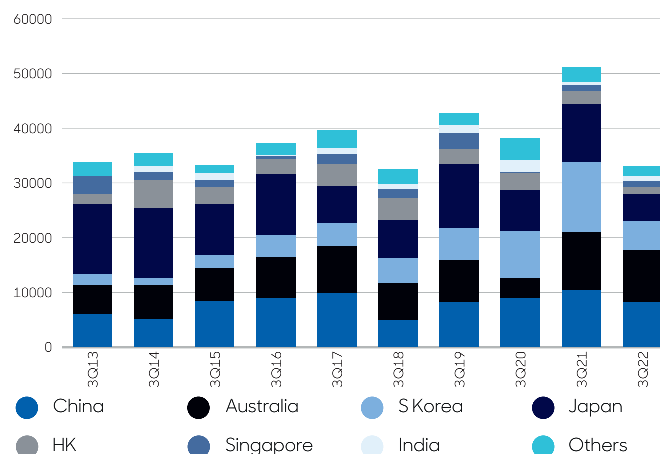
Investment Trends

- **APAC transaction volume: Singapore continued to outperform – for now**
Per MSCI Real Capital Analytics (RCA; Chart 3), APAC's commercial real estate transaction value (excluding development sites) in Q3 2022 was USD33.2bn, which translated into a 35% decline from the same period a year ago and the lowest Q3 tally in four years. The y-y decline was principally driven by less deals closing in Korea and Japan (-58% and -54%, respectively) during the quarter. Apart from a more cautious sentiment, the y-y comparison in Korea was also skewed by a couple of large transactions completed in Q3 2021, such as the KRW2.6trn (USD2.3bn) investment of a mixed-use project in Magok-dong, Seoul, and the KRW1trn (USD885.7mn) purchase of the SK Seorin Building in the Seoul CBD. On the other hand, Singapore and India were two markets in APAC that registered a y-y increase in transaction volume during Q3, up 9% and 84% respectively. One of the larger deals announced in Singapore during Q3 was the acquisition of 16 Collyer Quay for SGD1bn (USD714mn; entry yield sub-2.5%) by Bright Ruby Resources. Looking ahead, the momentum will likely slow on account of the surge in borrowing costs and more cautious occupier outlook. In fact, several large office deals have reportedly fallen through recently as investors become more cautious.
- **Australian logistics: Sydney urban logistics assets still transacting at sharp yields**
Notwithstanding the robust rent growth achieved by Australian logistics assets, cap rates in this sector have experienced the greatest pressure to expand in 2022. Per JLL's data, logistics yields were on average 25-50bp higher in Q3, resulting in an average sequential decline in capital values of 8.3% in Melbourne and 4.6% in Brisbane despite a respective rent growth of 7.1% and 2.4% during the quarter. According to RCA data, transaction volume of Australian industrial properties fell by 30%y-y in the first nine months of 2022. Investors' sentiment towards the sector has turned more cautious as interest rates rise while e-commerce penetration growth slows post-pandemic. Nonetheless, it appears industrial/logistics properties with solid attributes, especially those in Sydney, are still changing hands at relatively sharp yields. It was reported in early November that investor Pittwater Industrial has acquired a portfolio of three industrial/logistics assets in Sydney for AUD95mn (USD62mn) that translated into an initial yield of just 3.2%. The largest of the three is located in Mascot, South Sydney, and the agreed price presented a passing yield of 2.7%. The portfolio's relatively short weighted average lease expiry of 1.4 years could provide the investor the opportunity to implement value-add initiatives to capitalise on the assets' infill locations.
- **Tokyo CBD Grade A offices: yields continue to defy pressure to expand**
With the BOJ still the only dovish holdout among central banks in developed markets, it appears Japanese commercial real estate cap rates continue to defy the pressure to expand seen elsewhere. This is especially the case for prime offices in Tokyo. According to the latest bi-annual Japan Real Estate Institute (JREI) survey, investors' expected cap rate for Class A office buildings in Tokyo's prime Marunouchi/Otemachi area continues to trend lower to 3.2% (from 3.3% six months

ago, and 3.4% a year ago). In September, the tender for Otemachi Place attracted a winning bid of JPY400bn (or USD2.8bn), which represented a marked increase from the JPY300bn expected when the tender was first announced in July and was reportedly the largest real estate transaction in Japan's history. The bullish expectation stands in contrast to what appears to be weakening occupier market fundamentals. The average office vacancy within Tokyo's central five wards has stagnated at c.6.4% since 12 months ago, per Miki Shoji's data, while the average asking rent has continued to fall. Landlords in Tokyo are increasingly willing to offer rent discounts to fill up vacant space ahead of 1) a potential global recession, and 2) more supply of new office space scheduled for completion in 2023.

- **Listed equity fund-raising: Japanese logistics REITs were most active in Q4**
  APAC REITs' average price-to-book (P/B) multiple was more or less static at 1.1x by end-December 2022, from a quarter ago. The rise in long-term yields slowed in Q4, with the US 10-year bond yield gaining just 5bp during the quarter (from +82bp in Q3), which likely helped to calm the listed real estate market. Equity fund raising activity though remained slow in Q4, with the amount of new equity raised among REITs listed in Japan, Australia and Singapore announced during the quarter at just USD894mn (-74%y-y) per Bloomberg's data. Japanese REITs continued to account for the bulk of the fund raising activity in Q4 principally on account of still relatively dovish monetary policy settings. Logistics REITs were particularly active during the quarter, with GLP J-REIT's JPY32.1bn (USD219mn) raise announced in October and Nippon Prologis REIT's JPY24.4bn (USD177mn) raise announced in December representing the two biggest offerings in Q4. Proceeds from both capital raises were used to partially fund the acquisition of logistics properties from sponsors. Per JLL's data, market yields of Tokyo logistics properties continued to compress in Q3 to an average 3.3% (from 3.4%) notwithstanding higher vacancy (5%, from 4%) during the quarter. Room for further compression though is likely limited, in our view.
- **Debt-funding: rise in borrowing costs took a breather in Q4**
  As at end-December 2022, the option-adjusted spread (OAS) of the Bloomberg Barclays Asia USD Investment Grade (IG) Bond Index lost 9bp in Q4 (from +1bp in Q3) to end the year at 1.4% while the OAS of the High Yield (HY) Index shed 265bp during the quarter (from +25bp) to 10.47%. Beijing's rapid move away from "zero-Covid" as well as its announcement of additional financing support to domestic property developers likely helped to improve sentiment. As well, the rise in medium-term benchmark lending rates took a breather in most markets during Q4 though the rates remain at elevated levels. In Australia and Korea, for instance, the 5-year swap rates shed 39bp and 55bp, respectively, during the quarter but were still 214bp and 171bp higher than their respective levels at the start of 2022. In Japan, financial institutions' lending attitude towards real estate companies turned slightly more cautious, per the latest BOJ Tankan Survey, with the Diffusion Index (DI) reading down 1pt to 10 during the quarter (vs. 13 at the start of 2022). Importantly, the DI reading for higher interest rates on loans for all enterprises continued to rise in Q4 to 8 (from 6 in Q4 and 0 a year ago).

Chart 3: Transaction values for investment properties in APAC (excluding development sites) USD million.



Source: MSCI Real Capital Analytics, abrdn, December 2022.

Performance and Risk Outlook

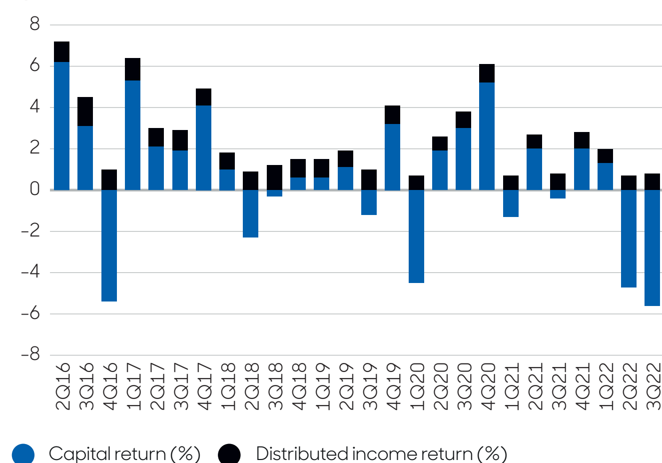
- **Non-listed real estate: negative capital growth increased in Q3**
  The Asian Association for investors in Non-Listed Real Estate Vehicles (ANREV) published its quarterly index for APAC Open-ended Diversified Core Funds (ODCF) on 1 December, with the total number of funds unchanged at eight but the total gross asset value (GAV) shrunk a further 1.4% to USD20.7bn in Q3, following the 1.9% decline during the previous quarter. Negative capital growth increased to 5.6% (from 4.7%) in Q3 – the sharpest quarterly decline in capital values since Q2 2016 when the series first began (Chart 4). This brought the net total return for the quarter to -4.9% (from -4% in Q2 and 0.4% a year ago). Similar to the previous quarter, we think Australian assets may have accounted for a significant portion of the markdown in capital values

"We think offices in Seoul and Singapore as well as industrial/logistics properties in Australia and Korea could present investors with attractive opportunities for capital deployment in 2023."

in Q3. Per JLL's data, apart from logistics properties in Melbourne and Brisbane which saw a respective capital value decline of 8.3% and 4.6% in Q3, CBD office assets in Australian capital cities also registered an average decline of between 0.7% (Melbourne) and 4.6% (Brisbane) in Q3. Per our comments last quarter, we believe the markdown in capital values has only just begun and negative capital growth will remain an overhang on returns in the near term.

- **Listed real estate: tourism-related stocks continued to outperform**
  Share prices of the major listed REITs in APAC registered an average increase of 3.4% in local currency terms during Q4, reversing the average loss of 6.9% in Q3. Hospitality REITs, especially the ones listed in Japan, maintained their outperformance during the quarter (+9%, from +6.7% in Q3) while investors' sentiment towards retail REITs (+6.7%, from -6.8%) and industrial REITs (+4.2%, from -8.2%) also improved. On the other hand, Japanese residential REITs (-5.8%, from -2.6%) and office REITs (-2.9%, from -9%) underperformed in Q4. Investors remain bullish on stocks related to the ongoing rebound in travel demand, especially with the announcement that travel restrictions in China will be relaxed from early January 2023. To put things in context, prior to Covid, visitors from China and HK accounted for a combined 35% of visitor arrivals in Japan, for instance. In the case of industrial REITs, valuations have been under pressure since the start of 2022 because their yields were the most compressed to begin with. Their stock underperformance in 2022, however, stood in contrast to the sustained strength of their occupier fundamentals. This is especially the case in Australia where rent growth was accelerating throughout 2022 amid record low vacancy in many cities.
- **Non-listed real estate: returns to deteriorate further in 2023**
  While 2022 was a challenging year for real estate investment returns on account of the rapid rise in borrowing costs, we think returns could deteriorate further in 2023 as the decline in capital values looks set to accelerate. We expect this to be led by offices, especially those in HK, Australia and China. Compared to a year ago, market yields of offices in HK, Australia and China have on average risen by just 1-7bp, per JLL's data. This suggests significant room for further yield expansion, considering the surge in borrowing costs (in HK and Australia) as well as the structural challenges in each of these markets. In the case of China, we expect the easing of Covid restrictions to allow more due diligence to take place, which should in turn translate into more transactional evidence to support a faster mark-down to market. That being said, it appears institutional investors' interest in APAC commercial real estate remains high, which should provide the foundation for an eventual recovery beyond the immediate term when interest rates could be trending lower. Of the top 10 unlisted real estate funds raised globally in Q3, three of the five largest have a mandate that targets the APAC region, per Realfin's data.
- **Risks skewed towards weaker growth, higher inflation**
  Macroeconomic drivers will continue to have an outsized influence on real estate's near-term performance. Our base case envisages multiple overlapping headwinds driving global recession, a moderation in inflation and thus interest rates back to the lower bound by late 2023. However, this is only one of several plausible scenarios that we see. There is the risk that inflation could be stickier than expected, which would imply a shallower rate cutting cycle than what we currently anticipate (and the economy will in turn take longer to recover vs. our base case). Imbalances in the Chinese property sector remain a concern, on top of what we have already factored into our base case. As well, the surge in Covid infections in China, following its faster-than-expected reopening, has increased the risk of viral mutations and "vaccine escape". Taken together, these scenarios constitute a risk distribution skewed towards weaker growth but higher inflation than what consensus currently expects – a challenging backdrop for investors to navigate. Other real estate-specific risks include higher need for capital expenditure, especially in offices. Sustainability targets and higher wellness standards will hasten the obsolescence of assets. While investors understand the risks, many may hesitate to take timely action in the face of rising construction costs.

Chart 4: Composition of net total return (%) – APAC open-ended diversified core funds



Source: ANREV, abrdn, December 2022

Investment Themes

- **Faster yield adjustments + rent growth = investment opportunities**
  We think offices in Seoul and Singapore as well as industrial/logistics properties in Australia and Korea could present investors with attractive opportunities for capital deployment in 2023. Per JLL's data, among the key markets in APAC, market yields in Korea and Australia have increased the most over the past year. In the case of Korea, the average market yield was 46bp higher than a year ago as of Q3 while the average yield in Australia was 8bp higher over the same period, led by the industrial sector (+19bp). A faster yield adjustment suggests valuation could bottom first in these market/sectors. Outside of Korea and Australia, market yields of offices and prime retail space in Singapore have also risen on a y-y basis (+14bp and +7bp, respectively). Higher and more attractive entry yields are just one part of the equation. The longer term outlook for rent growth is likely to be another important – if not more important – consideration. In this regard, the rent growth prospects for offices in Seoul and Singapore as well as industrial/logistics assets in Australia and Korea remain fairly robust, in our view. In fact, the yield adjustments so far have mostly been driven by higher rents rather than lower capital values.
- **Opportunistic, debt strategies likely to remain near-term focus**
  Of the three large funds that were raised in Q3 with a mandate to target the APAC region, two have an opportunistic strategy, according to Realfin. Per ANREV's data on closed-end real estate funds in APAC, funds with an opportunistic strategy and an initial close in 2007-08 during the GFC (Global Financial Crisis) have outperformed value-added funds of the same vintage. While the data does not go back far enough to provide a bigger sample size, it does support the view that an opportunistic strategy may work better for real estate investors heading into an economic downturn. We think private real estate debt strategies are also well-positioned to generate attractive risk-adjusted returns given rising rates and better protection of capital in the near term. Over the longer term, however, we think equity investors may still outperform in certain sectors such as Seoul offices and Australian industrial/logistics where the longer-term growth prospects remain intact. Finally, we reiterate our view that the performance between FACTS-fit (FACTS = Flexibility, Amenities, Connectivity, Technology and Sustainability) and lower-spec offices in most markets will continue to diverge and value-add strategies that focus on interventions to improve the asset's FACTS score are likely to do well over the longer term.
- **Will Japan remain an outlier?**
  As discussed in the earlier section, unlike the experience in most other developed markets in 2022, investors' expected cap rates for Japanese commercial real estate were in fact trending lower in most cases during the year. Apart from the example of Tokyo CBD offices cited earlier, offices in smaller regional cities such as Fukuoka and Sapporo (-30bp from a year ago in both cases) also witnessed a compression in investors' expected cap rates in the latest JREI survey. While we do not think the BOJ surprise in late-December was a signal that meaningfully tighter monetary policy is on the horizon, we think, on balance, the risks for Japanese yields are likely skewed to the upside. In Tokyo, the yield gap of all the major sectors is now below their respective long-term averages, which suggests valuation is rich relative to its own trading history. This is especially the case if we were to consider the near-term rent growth outlook for market/sectors, such as Tokyo offices, is weaker than what it was historically. That being said, on a more constructive note, we expect any increase in yields to be marginal and the overall proposition of Japanese real estate (i.e. attractive risk-adjusted cash-on-cash yields) to remain largely unchanged.

Min-Chow Sai

Head of Asia & North America Real Estate Investment Strategy

min-chow.sai@abrdn.com
[Email is not a secure form of communication so please do not send anything sensitive or personal]

+65 6395 2441

Ilyas Mohd Ismail

Research Analyst, Asia Pacific Real Estate Investment Research

Ilyas.mohdismail@abrdn.com
[Email is not a secure form of communication so please do not send anything sensitive or personal]

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