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Singapore Real Estate Outlook

THE ASIAN
ASSET SPECIALIST
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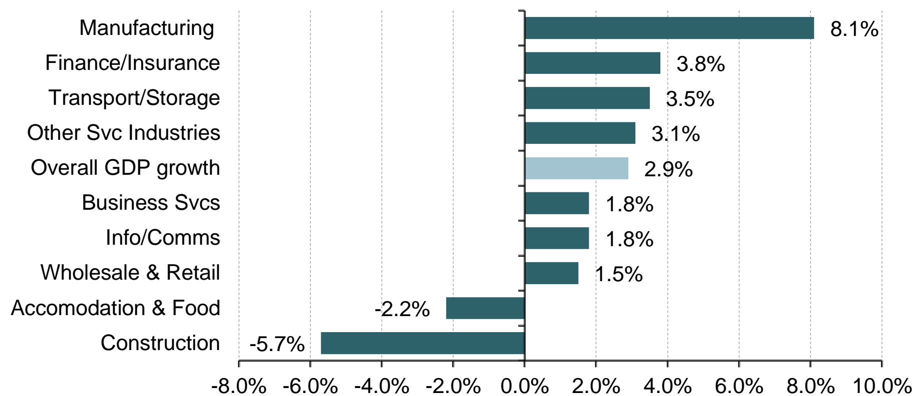
MACROECONOMIC OUTLOOK

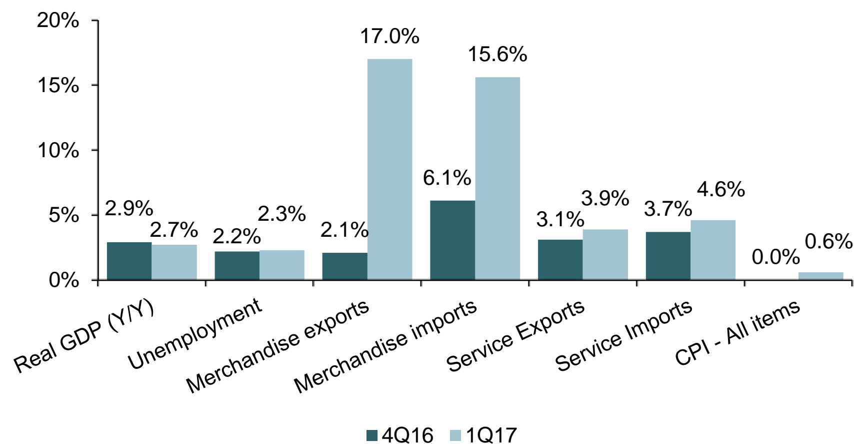
In line with regional trends, the Singapore economy has been performing better than expected in 2017. Both 1Q and 2Q 2017 GDP growth stood at +2.5% and +2.9%, respectively, with broad-based growth across all economic sectors. In the details, key contributors to 2Q 2017 GDP were in Manufacturing (+8.1 percentage point) and Finance/Insurance (+3.8 percentage point), led by an increase in semiconductor output and improved financial market activity (please refer to Chart 1). These two sectors more than offset weak laggards in the economy, being Accommodation and Food (-2.2 percentage point) and Construction (-5.7 percentage point). Notably, unemployment rate remains low at just 2.3% (please refer to Chart 2). Notwithstanding further economic shocks, the resilient year-to-date ("YTD") performance confirms our views of a modest recovery for the rest of 2017. This is also echoed by the Government's revised Financial Year 2017 GDP growth forecast of 2.5%.

Chart 1: Percentage point contribution to growth in real GDP, in 2Q 2017 (by industry)



Source: Ministry of Trade and Industry, Singapore; as at June 2017

Chart 2: 1Q 2017 snapshot on the Singapore economy – all figures in year-on-year comparison, except for unemployment rate (stock figure)



Source: Ministry of Trade and Industry, Singapore; as at June 2017

SINGAPORE REAL ESTATE 2017 / 2018 OUTLOOK

Most real estate sub-sectors have been in a down-cycle in the past few years; led by over-supply and subdued demand trends. Given the improving economic outlook, we think the various real estate markets are beginning to recover, with most real estate subsectors in the "Bottoming" quadrant of the Singapore real estate property clock (please refer to Chart 3). A stronger-than-expected economic rebound will accelerate this recovery.

Within the various sub-sectors, we see both Office and Hospitality sub-sectors at a later stage of the recovery, compared to both Industrial and Retail sub-sectors. This is due to factors such as the cyclical nature of the Office

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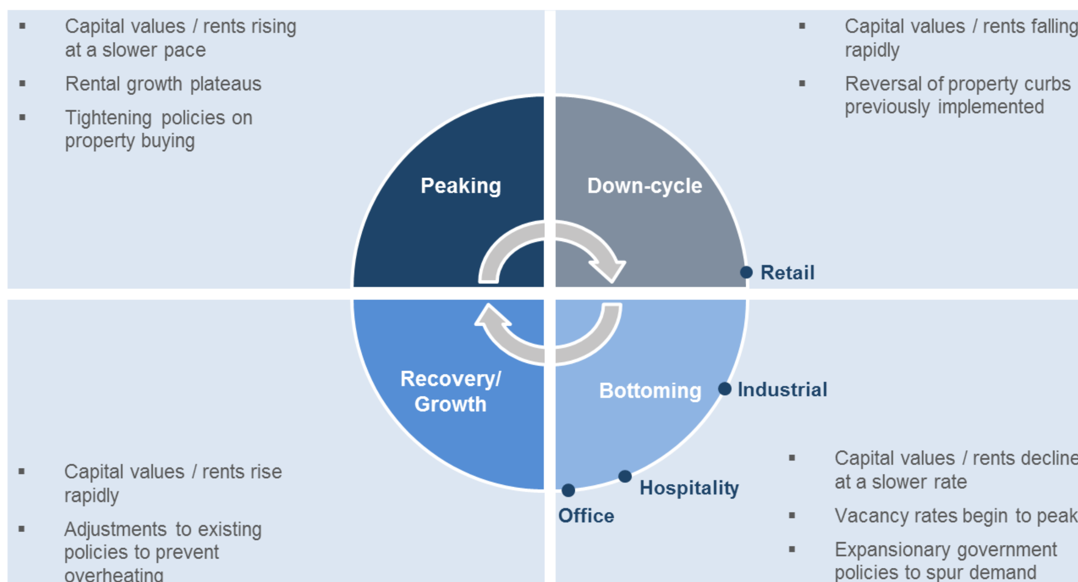
and Hospitality sub-sectors, the two sectors being highly correlated against economic growth and China outbound tourism flows. Moreover, both Office and Hospitality sub-sectors are emerging from a multi-year down-cycle, due to prolonged supply pressures in the past two to three years. Retail continues to be a key laggard, being in the "Down-cycle" quadrant. Retail fundamentals in our view are still subdued from weak consumer sentiment, but we expect this to improve alongside the economic recovery.

Chart 3: Singapore real estate property clock



Source: Lion Global Investors; as at August 2017

INDUSTRIAL: GRADUALLY IMPROVING OUTLOOK

Singapore's industrial sector has undergone a soft patch post the global financial crisis, as Singapore is highly dependent on trade flows and exports. This was further compounded by an increase in supply pressures for the past three years, which further increased sector-wide vacancies from 4-5% to 10-12% (please refer to occupancy levels in Charts 4, 5 and 6). Despite an improved economic outlook YTD, most industrial tenants remain cautious on leasing decisions, citing unclear growth prospects and a preference to contain operating costs. There has also been the prospect of businesses relocating to lower-cost countries (e.g. Malaysia), but such trends have not been prevalent given the lack of skilled labour and efficient cross-border logistics overseas.

That said, we see the various industrial sub-segments registering different growth trajectories. Amongst all three sub-segments, we expect Business Parks to have the most resilient outlook, noting limited supply pressures within the next two years (of around 43,000 sqm) (please refer to Chart 4), and noting its resilient positioning as a cheaper alternative to Grade A Central Business District ("CBD") office leases. Financial tenants such as Credit Suisse and DBS have part of the back office operations in Business Park space in a bid to keep operating costs lower. Business Park rents in general are around 40-50% lower than comparable Grade A CBD offices, based on our estimates. Newer Business Parks (e.g. in Changi, One North and Alexandra) have been positioned to benefit from the government's push for Singapore to become a smart nation. More spaces are being taken up by startups to incubate new business ideas.

We see greater near-term pressures in both Flatted Factories and Logistics sub-sectors, with these two sectors still registering weak demand and with near-term supply pressures (please refer to Charts 4, 5 and 6). However, we expect supply pressures to subside from 2018, with a marginal pickup in leasing demand as the economy recovers. We expect industrial spot rents to track a U-shaped recovery.

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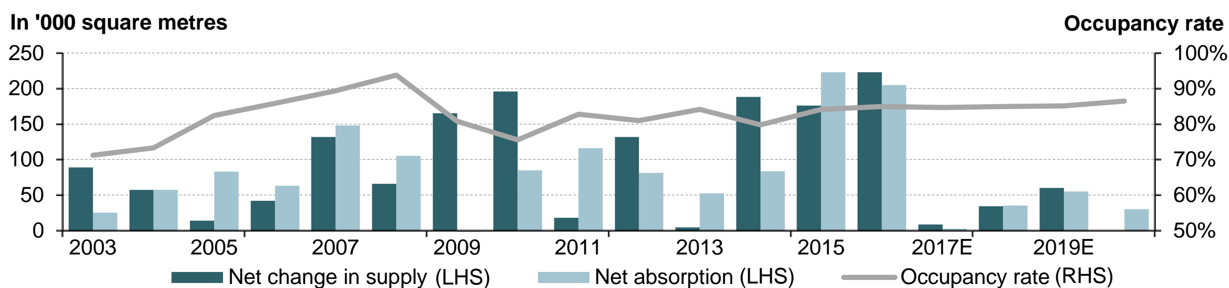
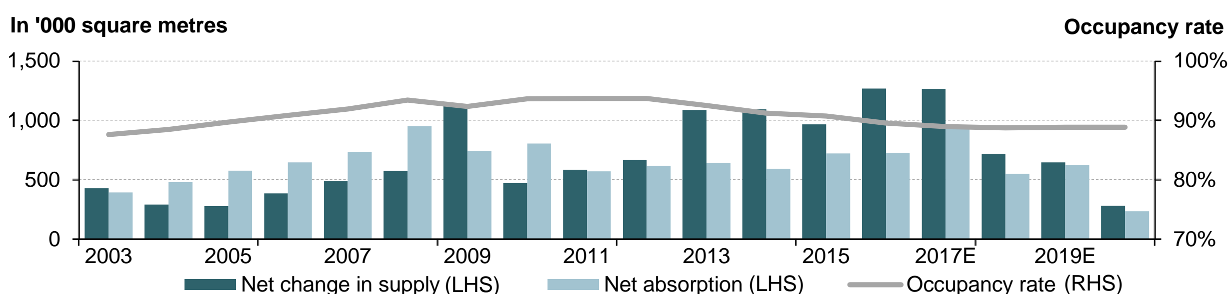
Chart 4: Industrial Business Park demand / supply trends



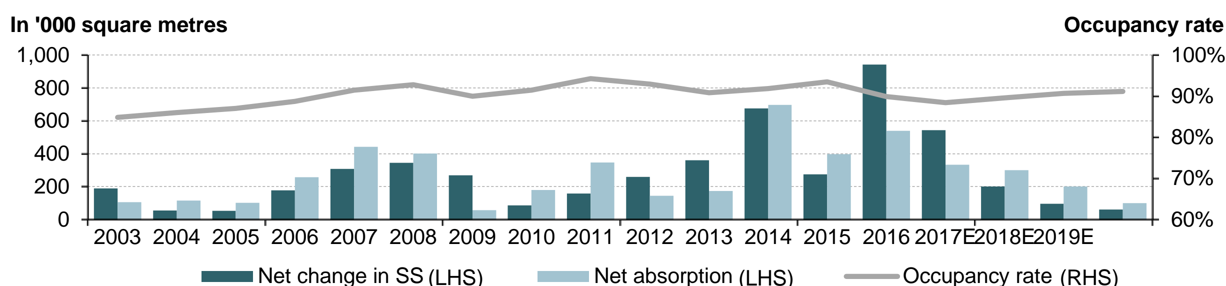
Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 5: Industrial Flatted Factories demand / supply trends (single / multiple)



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 6: Logistics (warehouse) demand / supply trends (single / multiple)



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

OFFICE: BOTTOMING OUT

The office market has been in a down-cycle in the past two years, with market rents declining by 20% since 2015 (please refer to Chart 7). Key drivers behind this down-cycle came from i) weakened demand (as expansion plans slow down and tenants consolidate space), coupled with 3.8 million square feet ("sqft") of supply coming onstream from 2016 to 2018 (please refer to Chart 8). In view of these trends, office landlords have been defensively protecting their portfolios, by lowering renewal rents and protecting portfolio occupancies. These strategies have accelerated the office rent down-cycle, in our view.

In recent quarters, the office market is showing signs of stabilizing. While there have been some improvements in leasing demand (particularly from non-financial service tenants), bulk of the leasing activity has been driven by relocation demand, rather than new-to-market demand. Most tenants have taken the opportunity to relocate to newer office buildings, at similar rent levels. The improved supply pre-commitments have also provided landlords with better pricing power, many of which have been scaling back forward renewals and attempting to increase asking rents. Looking ahead, we believe that better demand / supply dynamics will benefit office landlords over the next few years. There will be no new office supply in the core CBD area between now and 2020 and we believe that

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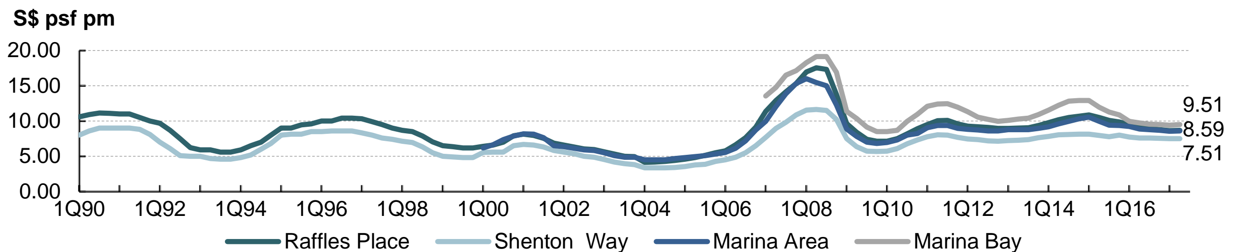
this, together with stable demand on the back of improving economy, will help push rents higher from current low levels.

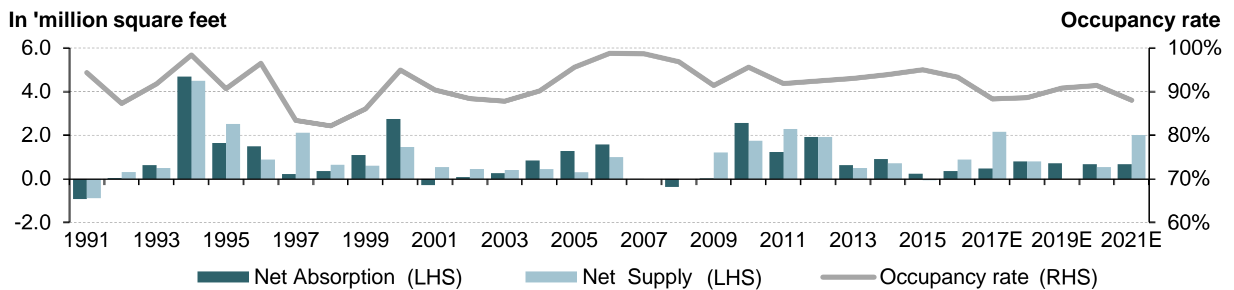
We note that physical asset valuations remain robust (please refer to Chart 9) and driven by continued capital inflows into the physical market. Being a deep liquid market (both in terms of frequency and ticket size), office assets tend to be frequently traded as compared to other sub-sectors.

Chart 7: CBD Grade A office micro market spot rents



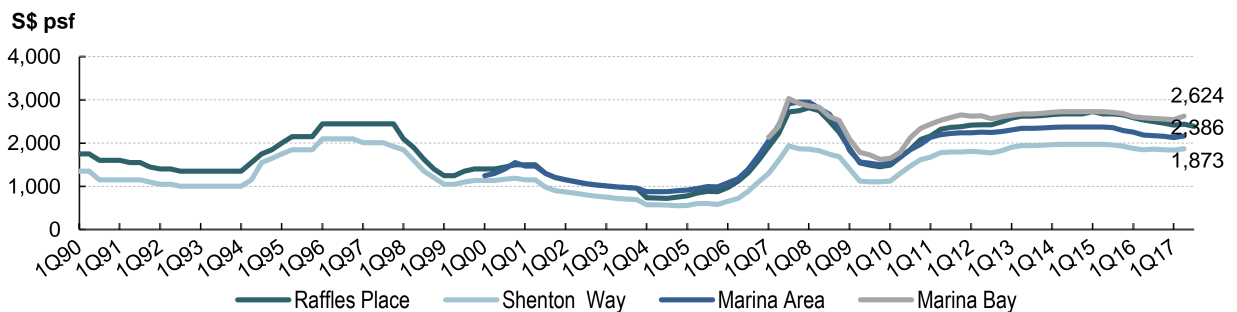
Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 8: Annual Grade A CDB office demand / supply trends



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 9: CBD Grade A physical capital values



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

HOSPITALITY: CLEAR SIGNS OF A SECTOR RECOVERY

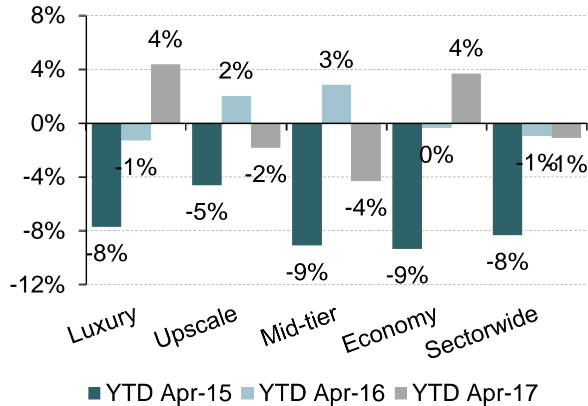
Apart from the residential sector, we see clear signs of a Hospitality sector rebound in 2017 / 2018. This is on the back of a prolonged down-cycle in the past two to three years, led by weak tourism visitations, cutbacks in corporate spending, and persistent supply pressures (of 4-6% p.a.), based on our estimates This has resulted in a 15% decline in revenue per available rooms ("RevPARs") since the 2013 peak.

We believe 2017 marks an inflection point for the hospitality sector, seen through improving RevPAR trends in the listed Hospitality Singapore real estate investment trusts. Hoteliers are now starting to see improved bookings from

higher-paying corporate customers (comprising approximately 50% of overall revenues). There has also been a recovery in the Leisure segment with an improvement in tourism inflows (+4.4% year-on-year ("Y/Y") for YTD April 2017), and aggregate tourism spend (+15% Y/Y increase for 1Q 2017). The improvement in Leisure tourism is also echoed by similar trends across the Hospitality industry (based on our estimates and corporate discussions).

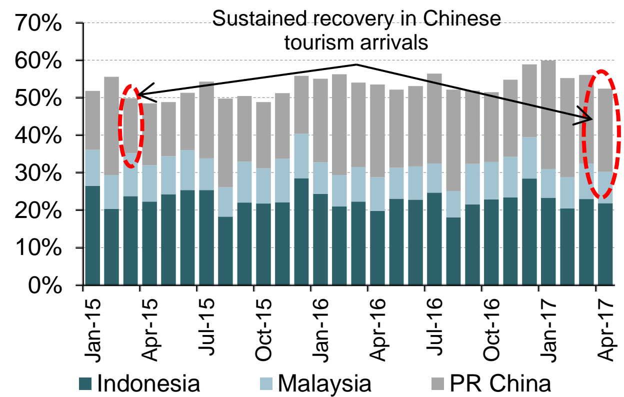
Moreover, we think this recovery will be supported by a reduction in supply, with 2018 annual hotel supply growth moderating to 2% Y/Y. This is significantly lower than the 4-6% supply growth seen for the past few years. Being a cyclical sector, we think the hospitality demand should be quick in responding to an economic upturn.

Chart 10: YTD April Y/Y RevPAR trends by segment



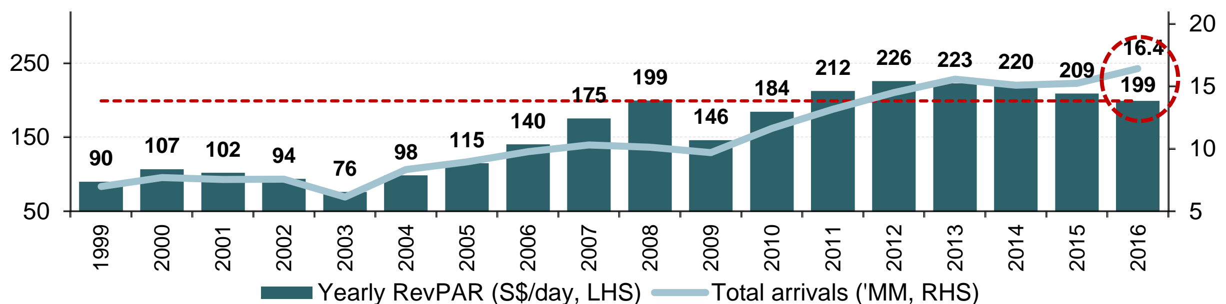
Source: Singapore Tourism Board; as at April 2017

Chart 11: Breakdown of top 3 inbound tourist markets



Source: Singapore Tourism Board; as at April 2017

Chart 12: Sector-wide RevPARs (LHS) vs. total tourist arrivals (RHS)



Source: Singapore Tourism Board; as at April 2017

RETAIL: WEAK CONSUMER SENTIMENT ON THE MEND

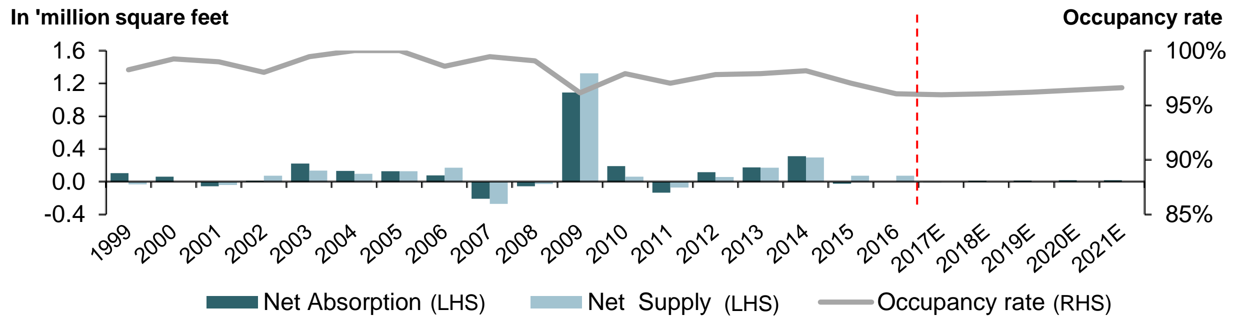
The Retail sub-sector remains as a key laggard within Singapore Real Estate. Key headwinds in the last few years include: i) weak consumer sentiment (impacting retail sales); ii) the rising influence of e-commerce (being a substitute for physical retail stores); and iii) rising labour cost pressures (influencing tenant profitability / expansion plans). We also saw selective supply pressures in suburban retail, with the opening of two big retail malls in the West (JEM and Westgate). The combination of these pressures has led to a 10% decline in retail rents since 2016; the first spot rent decline post the Global Financial Crisis. That said, retail remains a resilient asset class, with occupancies still high at approximately 97%.

In general, suburban retail is more resilient as compared to prime retail, given the non-discretionary nature of suburban retail. We have also seen landlords re-adapting to the changing retail landscape, either by lowering asking rents and / or re-calibrating trade mixes within the portfolio. Within the various trade mixes, Fashion tenants have been most impacted, whereas Services and F&B tenants have been popular leasing options for landlords.

We expect retail fundamentals (both rents and retail sales) to recover as tenants gain confidence on leasing decisions and underlying profitability. This in turn will help to boost retail sales, and provide better pricing power for the landlords. More importantly, we note that malls held by REITs are generally in superior locations with higher

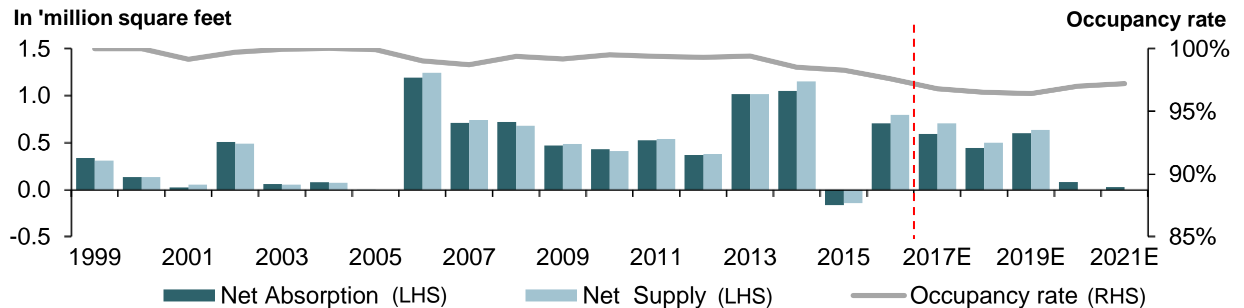
footfall and bigger catchment area. Furthermore, malls under REITs are also better managed and have greater network benefits as compared to other individually operated malls. As such, we believe that such malls will outperform the market, even in a weaker operating environment.

Chart 13: Prime retail demand / supply trends



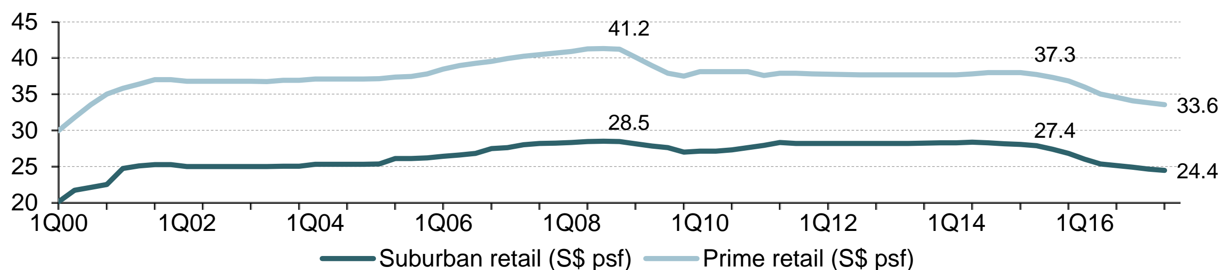
Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 14: Suburban retail net demand / supply trends



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

Chart 15: Retail spot rent trends (prime and suburban)



Source: Jones Lang LaSalle, Bank of America Merrill Lynch; as at June 2017

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