Coronavirus and the impact on the Asian real estate market

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The current coronavirus is creating a great deal of uncertainty. To help our clients better address the situation, we have put together an initial assessment of the impact on real estate strategies. Given the fluidity of circumstances, we intend to provide periodic updates. If you have any questions, please reach out directly to our contributors listed at the end of the paper. We very much welcome your feedback.

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Contents

Introduction 4
Economy 8
Office 10
Hotel 12
Retail 13
Industrial 14
Residential 15
Capital Markets 16
Future Trends 18
Introduction

The primary impact of the coronavirus is being felt in Mainland China, with Wuhan, the capital of Hubei province, most affected. The Chinese government has taken significant steps from a humanitarian perspective to address the outbreak and to contain the virus.

With the outbreak of any new virus comes a high degree of uncertainty. As such, healthcare specialists and governments around the globe have taken significant precautionary measures aimed at limiting further spread of the virus, including issuing proactive healthcare advice and imposing limitations on the movement of people.

We do not aim to provide any expertise which is medical in nature. We also recognize the very real human impact that the coronavirus outbreak is currently having on those directly or indirectly affected. Within this note, we aim only to address the longer-term potential impact on the performance of real estate markets.

Inevitable parallels are being drawn between the coronavirus and SARS. We found that the impact of SARS was relatively muted on real estate markets, and did not derail the long-term rental performance. At the time, investment deal flows were delayed but bounced back strongly when SARS receded. However, economic conditions and the stage of the real estate market cycle are different now.

Should the coronavirus be contained swiftly, we expect the financial impact to real estate markets to be relatively short lived, even in those markets most affected. However, performance would be expected to vary across sectors.
The coronavirus outbreak could potentially be a high impact, but short-lived event, similar to the 2003 SARS episode. This scenario poses a notable downside risk to our Mainland China and Hong Kong growth forecast in 1Q and possibly 2Q, depending on its duration and severity.

On the macro level, consumption and travel will be the most affected. Corporate travel restrictions will hinder current and planned market trips to carry out due diligence, causing some delay to investment deal flows. There could also be some supply chain disruption in the short term.

**Office**

Businesses are likely to delay real estate decisions. This may also pave the way to more flexible work practices (not necessarily co-working space but work from home arrangements) in the medium term. The situation will add to ongoing supply challenges in Mainland China and Hong Kong.

**Retail**

Retail turnover could fall, particularly in Mainland China and Hong Kong. Rents to face more downside pressure due to earlier closures for some weaker trades or outlets. Similar impacts may be felt in markets where Mainland Chinese tourists account for a high degree of retail receipts.

**Industrial**

Demand for logistics facilities from e-commerce retailers and 3PL companies is likely to remain resilient. Firms in the manufacturing sector may further examine supply chain implications and contingency planning if the outbreak persists for a protracted period.

**Residential**

Residential launches are likely to be pushed back across many markets, including Mainland China and Hong Kong, as sentiment is dented by uncertainty.

**Investment**

Asia Pacific investment volumes in 1H 2020 are likely to be sharply lower year-on-year as investors re-examine investment pipelines and deployment. However, using SARS as a benchmark, we expect investment volumes to bounce back as risks recede in 2H 2020. Capital values are likely to hold up and yields could compress if rents and occupancies are affected in the short term amid low interest rates.

**Outlook**

Occupiers will increasingly seek high-spec real estate with a view to providing a safe and healthy workplace for staff. The outbreak may further spur development of business continuity planning and proptech in the longer term.
Wuhan

Major industrial and commercial hub of Hubei

11 million people
Wuhan’s population, less than 1 percent of Mainland China’s total

USD 224 billion
Wuhan’s gross domestic product in 2018, 1.6 percent of Mainland China’s total

319 million arrivals
to Wuhan in 2019

More than 300 Fortune 500 companies
had operations in Wuhan in 2019
How are things different?

There are several potential downside risks that could result in a more severe impact this time around according to Oxford Economics. We recommend our clients to consider the following factors:

- Recent spikes in confirmed cases
- A broader geographic infection radius than SARS
- Mass nationwide movement of people before and after Chinese New Year holidays presents ongoing serious challenge to containment of the outbreak

- Mainland China’s economic activity, human mobility, international market connectivity in 2020
- Holiday extensions translate into fewer working days in 1Q
- Quarantine of affected regions impacts local economies and reverberates through supply chains weighing on other regions
Coronavirus raises downside short-term growth risks

Initial estimates from Oxford Economics forecast Mainland China’s GDP growth could decline by around 2.0 percentage points in 1Q (0.6 percentage points for full-year 2020).

Consumption will be the hardest hit given the widespread outbreak and strict containment measures in Mainland China. The softer business sentiment resulting from the outbreak is also likely to weigh on investment and exports.

Mainland China’s economy has grown nine fold since 2002, and greater connectivity will result in spillover effects. This is particularly so for Asia Pacific economies who have a greater reliance on tourism revenue from Mainland China travelers.

Fortunately, many governments in the region have scope to support their economies and are likely to take an accommodative policy stance. Mainland China’s central bank has already injected liquidity into the market and more moves are anticipated. Other regional governments have announced plans to implement more stimulus programs once the immediate health concerns are under control.

As long as the number of coronavirus cases remains low in the rest of the world, the impact on the global economy is likely to be moderate and temporary.

However, if issues remain pronounced and the virus period is protracted, it could potentially disrupt the phase one Mainland China and US trade deal as exports to Mainland China are delayed. Nonetheless, Mainland China has stated its commitment to the deal and will cut tariffs on many US goods on February 14th.
Economy

Looking back at the SARS impact

SARS was only a relatively modest drag on Mainland China’s economy during 2003, with GDP growth slowing from a robust 11.1% y-o-y in 1Q to 9.1% in Q2. Strong economic growth was supported by structural changes taking place following the country’s entry into the WTO in late 2001.

Fortunately, most cases of the illness at that period were concentrated in a relatively small area compared to the current outbreak, and the national economy was also much less interconnected than it is today.

Hong Kong’s economy, on the other hand, was hit hard, particularly consumption, by a short but sharp contraction during the SARS period given the relatively high concentration of cases and deaths.

Nonetheless, a strong rebound was witnessed in Hong Kong aided by measures which started to open up Mainland China’s economy and the introduction of the individual visitors scheme.

Similar to Hong Kong in 2003, Singapore was also coming off a period of protracted weakness and after a steep decline during SARS its economy bounced back quickly benefitting from supportive government measures and Mainland China’s economy opening up.
Economic and political uncertainty have been presenting headwinds to office markets, with rental declines evident and forecasted in some key markets before the outbreak began. This current event is likely to add to risks, at least in the short term, as businesses delay real estate decisions and enhance emphasis on managing costs and business continuity plans.

In Mainland China, uncertainty will cause occupiers to be more cautious and adopt more conservative leasing strategies. The impact will depend on the length of the outbreak. Once the outbreak is fully contained, office demand is expected to rebound. In the long term, office markets will be supported by the continued expansion of the technology industry and financial liberalization.

We had expected businesses to delay real estate decisions due to social events in Hong Kong. Given the outbreak, these decisions will likely be further dragged out as companies assess the outbreak’s impact on their business prospects. If we look back at 2003, Hong Kong office rents surged considerably from historic lows after SARS, alongside an economic recovery. We expect a repeat is unlikely as Hong Kong office rents just started to come off historic highs after a prolonged upcycle.

Inevitably this situation has the potential to weigh on business sentiment if prolonged; however, at this moment we expect office leasing demand in Japan to hold up relatively well. Some corporates may ask employees to work from home or from satellite offices. This could support more flexible office demand (not necessarily co-working space), particularly to avoid traffic during the Summer Olympics in Tokyo.

The outbreak may also weigh on sentiment across most industries in Singapore. As a result, softer business sentiment could lead some firms to hold back on relocation and expansion plans.
Mainland China

Robust economic growth following entry into the WTO helped sustain demand during SARS with only a small dip in absorption recorded.

Mainland China’s office markets were relatively immature, resulting in the growing number of MNCs competing for a limited amount of quality stock.

The healthy underlying fundamentals helped limit the drop in rents during this period.

Hong Kong and Singapore

SARS contributed to an already weak demand environment in which both the Hong Kong and Singapore markets were dealing with an ongoing trend of corporate retrenchment which started in the early 2000s.

The outbreak saw some MNCs place focus on reducing costs and others on business contingency planning.

Rentals trended downwards through this tumultuous period in both markets, declining about 20% and 15% in Hong Kong and Singapore respectively during 1H03. While Hong Kong rents started a recovery once there were visible signs of improvement, Singapore witnessed a further decline due to a supply overhang.

Note: Office leasing markets in both Shanghai and Beijing were relatively embryonic in 2003. Rental changes are on a local currency basis and refer to the main submarket in a city.
Source: JLL, 4Q19

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Hotel

Inbound tourism a key driver of hotel and retail markets

Outbound tourism from Mainland China has grown rapidly in the past two decades with this group becoming the largest spenders globally—estimated at nearly USD 280 billion in 2018 by the UN World Tourism Organization.

Hong Kong, Malaysia, Philippines, Singapore and Thailand, amongst others, have seen tourism industries become major contributors to local economies. Each has benefited strongly from the rise in Chinese visitation, with this group now either the largest or amongst the greatest source of foreign arrivals.

The influx of tourists has driven a need for accommodation and retail related industries such as F&B, recreation, fashion and accessories, as well improved transportation infrastructure to support the higher flow of people.

![Air passengers in Mainland China](image)

Source: Civil Aviation Administration of China

![Spending by Chinese Tourists](image)

Source: JLL estimates based on data from Oxford Economics
Market performance was mixed across the region during SARS. Areas that recorded a higher number of cases of the illness, including Hong Kong and Singapore, were more impacted by the temporary slowdown in activity as locals avoided public places and tourist numbers declined.

In the current environment, infection control measures have caused retail turnover in Mainland China during the Spring Festival Golden Week to fall well short of expectations. Several landlords have decided to reduce malls’ opening hours, cancel promotional activities and shut down operations of potentially crowded spaces. That said, many fashion and F&B brands are putting more emphasis on home delivery services to compensate for losses from their physical stores. This situation adds to an already difficult operating climate.

High social tensions in Hong Kong—already an unfavorable backdrop—coupled with the unfortunate timing of this outbreak during the Chinese New Year, have dealt another heavy blow to the frail retail sector. Despite the perceived temporary nature of the outbreak, it may prompt earlier closures of weaker trades or outlets. In turn, more owners are likely to be forced to compete for tenants, exacerbating the rental down trend.

Travel restrictions are likely to weigh on many retail markets as long as they remain in effect. Japan’s prime retail market may be one of these places impacted, as consumption of luxury goods at department stores would likely slow if tourist arrivals dip. Although, spending by overseas tourists is still a relatively small component of total national retail sales.

Note: Changes are on a local currency basis and reflect shopping centres unless specified. Prime retail markets in Beijing and Shanghai were embryonic at the time with limited stock.
Source: JLL, 4Q19
Demand from e-commerce retailers (a major driver for logistics) should be relatively unaffected. E-commerce is likely to benefit from this situation as shoppers gravitate towards buying from the safety of their homes, which should support demand for 3PLs companies as e-commerce firms are major customers.

There may be increased warehousing demand for fresh food and medical supplies. In addition, the push for higher standards in the pharmaceutical and food industries could be a boost to cold chain logistics—one of the most demanding segments of logistics real estate.

Quarantines and supply chain disruptions, however, may lead to a decrease in Mainland China’s industrial production and exports resulting in a reduction in warehousing demand by manufacturers in the short term. Amongst Mainland China’s top trading partners, Japan, Korea and Australia may see weaker warehousing demand.

In the long term, more investment into modern logistics / smart warehousing presents an exciting opportunity for investors.
Residential markets are largely driven by local market dynamics, however, this outbreak is likely to influence sentiment and potentially see buyers shy away from viewings until the situation is under control. Travel curtailment whether mandatory or voluntary, also means that foreign purchases will slow down, at least in the near term, thus possibly affecting sales volume in some markets.

The typical seasonal sales recovery post-Chinese New Year in Hong Kong will likely be pushed back as developers opt to avoid launching new projects during this period. Primary sales will stay at low levels while the secondary market will also be slow as prospective buyers take a wait-and-see approach. Pricing will likely take a slight hit due to fragile sentiment overall. We maintain our forecast that capital values will be under pressure as demand/supply dynamics will stay largely intact.

The Mainland China residential market is expected to come under pressure in the short term as the coronavirus outbreak has curbed demand and off-plan sales, although the impact is likely to ease after 2Q. Housing sales from migrant professionals and workers will see a significant drop this quarter. Developer brands such as Country Garden, Sino-Ocean, China Jinmao, Vanke and Yuexiu have also announced the closure of their sales offices in some cities.

Note: Capital value changes are on a local currency basis.
Source: JLL, 4Q19
Markets structurally different now

It is difficult to draw any parallels with the SARS period, which coincided with the Iraq War and weak economic recovery post the 2001 recession. Globally, interest rates in 2003 were also higher than the current record low levels.

Nevertheless, we expect the impact of the outbreak on Asia Pacific capital markets to be sharp but short lived, based on how SARS unfolded. While transaction investment volumes in Hong Kong, Mainland China and Singapore declined sharply in 1H 2003 as sellers held back, activity resumed in 2H 2003. As a result, all three markets exhibited a downward trend in cap rates over 2002-2004 as expectations of economic recovery picked up and investors did not demand an increase in risk premium.

In 2H 2003, as fears about SARS receded, the Hong Kong investment market became active and several notable en-bloc office transactions took place as bidders were more aggressive. Grade A office capital values in Hong Kong declined only by a cumulative 18% between 1Q and 3Q 2003, much less than the 30% rental decline, as investors continued to look at opportunities.

Moreover, Mainland China’s investment markets were still at an embryonic stage in 2003, with limited investible assets and much lower transaction volumes than today.

Note: Capital values changes are on a local currency basis and refer to the main submarket in a city. Source: JLL, 4Q19
Investors to remain selective

Investment deals take several months to close, so the impact on deal volume should be limited if the outbreak dies down in 3-6 months. Transaction volumes may pull back slightly in 1H20 as some investors take a wait-and-see approach and delay deals across the region. However, if the outbreak is short lived, we expect pent up demand for Mainland China investment to be released into the market in 2Q or 2H.

Going into 2H, deal volumes across Asia Pacific should rebound due to accommodative policies, which would help buffer any risk premiums.

Asset classes may diverge in terms of performance. If the impact lingers, poor operating performance in retail and hospitality may be expected, and office and logistics assets may gain more relative favour from investors. Investors may also focus more on deals in markets such as Australia and Japan and monitor the uncertainty in Greater China in the short term.

Existing softer sentiment in Hong Kong is likely to weaken further. Prospective investors are likely to demand higher yields to compensate for the heightened risk. Vendors with holding power are likely to remain firm clinging onto the temporary nature of the outbreak. We expect low transaction volume in 1H20, or until more certainty about the epidemic being contained emerges.

Investors in Mainland China had already been picking assets more carefully, demanding lower entry prices on purchases and taking longer to make a decision. On the whole, investors are still actively looking for assets in Mainland China, especially in Tier 1 cities. We still see new investors entering the market and many others are looking to increase their allocations. Domestic capital controls may also help limit outflows.
Future Trends

Possible long-term implications

More scrutiny on asset specifications and quality stands out as our key takeaway in this fluid situation. The infectious nature of the outbreak is a reminder of the importance of high standards of personal and community hygiene. This has to be extended to the provision of real estate too. For example, it is imperative that buildings are built to an assuring standard with good ventilation and filtration systems in place. Occupiers will increasingly seek such provisions with a view to providing a safe and healthy workplace for employees.

Greater focus on business continuity planning (work-from home in particular) will gain traction. This may prompt:

(1) more businesses to engage tech support, hence related service providers are in demand;

(2) increased demand for data storage and data centre providers.

The quicker adoption of proptech is also a possible implication. Landlords, governments and occupiers may look to support the development and adoption of a range of products/solutions, which could enhance workplace safety, such as:

**Robotics:** demand may rise for robotics applications that can detect, sanitize, clean, and conduct deliveries in public spaces such as office buildings, shopping malls, and medical facilities.

**Internet of Things (IoT):** Building managers can implement IoT strategies to enhance sanitation and health-related monitoring procedures in public spaces, such as the use of sensors to perform infrared scans, pinpoint crisis locations and send alerts.

**Big data:** demand for enhanced analytics to track and monitor high-risk public incidents may rise. The outbreak may push governments to prioritize accurate information collection in densely populated areas such as high-rise buildings and shopping malls.

**Unmanned vehicles/aerial vehicles (UVs/UAVs):** these tools could be a long-term solution for logistics and supply chains dealing with physical quarantines and/or labour shortages.

**Healthcare:** there will be a renewed focus on the need for higher quality facilities and services across the region, especially in Mainland China. Healthcare spending in Mainland China alone has soared from less than CNY 500 billion in 2000 to over CNY 5 trillion in 2017. This momentum is likely to maintain as the government commits to improving access and as society becomes more aware of disease prevention and healthcare awareness.