Office bound

In the split-screen office world, some investors enjoy high occupancies and rising rents, while others face high vacancies and declining values

by Mard Naman

The office sector has faced a torrent of bad news the past few years and lost its appeal for many investors. But the really bad news has been coming mostly from the United States and Europe. Asia Pacific office? It is not nearly as bad and has more positive trends going forward.

"The office sector is currently undergoing a transition in the US and Europe, and to a lesser extent in Asia," says Simon Shen, senior managing director and fund manager for Hines.

Despite a global office downturn, there are attractive Asia Pacific opportunities for investors who know where to look and what to look for. "Office fundamentals have generally remained resilient in most key developed Asia markets," notes Shen. "Our research indicates net office absorption in developed Asia has rebounded above long-term averages." In particular, with limited to little impact from work-from-home during and post-COVID, overall office demand has stayed strong in South Korea, Singapore and Japan.

This stands in stark contrast to the US office situation. It is no secret the US office market has been facing unprecedented challenges. The terms "historic meltdown in demand" and "nuclear winter" were used recently by Paul McDowell, president and CEO of Orion Office REIT, in a speech at a Nareit investor conference.

In major US cities such as New York City and San Francisco, occupancy levels are still way down. Remote and hybrid work have reduced NYC office space occupancy to about 40 percent of pre-pandemic levels, for example, and commercial real estate values have dropped as much as 50 percent in some parts of the city, according to an article from the Columbia Business School.

Nationally, it is likely to get worse before it gets better. According to a June analysis by Moody's, the US office vacancy rate could jump from 19.8 percent in the first quarter of 2024 to 24 percent by 2026, potentially reducing values by as much as US$250 billion and costing landlords US$8 billion to US$10 billion in lost revenue.

Asia Pacific has been getting back to the office

Such dire predictions are not happening for Asia Pacific office. *Emerging Trends in Real Estate Asia Pacific 2024,* a report from PwC and the Urban Land Institute, notes the "hollowing out" of office markets that has happened in North America and Europe is unlikely to be repeated in Asia Pacific because employees are much less entrenched in work-from-home routines. Most Asia Pacific markets have been getting back to the office. In fact, *Emerging Trends* says in cities such as Seoul and Shanghai, occupancy rates were already back to pre-pandemic levels at the beginning of 2024. However, work-from-home remains strong in Australia.

But the work-from-home phenomenon has not made significant inroads into most other Asian markets due to several factors, including the importance of face time, less reliance on long car commutes, and smaller apartment sizes, according to Shen. "These factors will continue to remain relevant to investors interested in office markets in Asia," he says.

Globally, more than 70 percent of the workforce is back in the office, according to Hines' June midyear report, *Walking Through the Threshold*. "We must remind ourselves that work-from-home appears to be largely a US challenge," the report states. At the same time, the report highlights that trophy-grade office has continued to see positive demand despite market challenges.

While Asia Pacific occupancy rates have been much less affected than in the West, "office assets have not been immune to ongoing global reset," *Emerging Trends* notes. Asia Pacific office has been "tainted by association, with investors avoiding offices like an allergy as they take their cue from collapsing values in the West."

Regional prime office rents overall have trended downward for eight consecutive quarters, according to Knight Frank's *Asia Pacific Q2 2024 Office Highlights* report. The good news is the most recent numbers are stable, suggesting the regional office sector may be approaching a turning point.

Significantly, 15 of the 23 monitored cities reported stable or increasing rents year-over-year. This points to a split-screen, highly bifurcated region. "This resilience in select markets suggests that some areas are weathering the regional

Australia's office struggles

Australia's office market remains strained, with a strong work-from-home trend similar to North America's. Office-focused funds reported a –16.34 percent annual return, according to a July ANREV report. According to market commentary in the report from Jade Tan, portfolio manager at APG Asset Management, "Though transactions have resumed, pricing may take a while to bottom out as cost of debt and inflation remain persistently high, and there has been renewed volatility in the interest-rate outlook."

The underperformance of Australia's office sector is a reflection of weak fundamentals. Lease negotiation periods remain protracted with minimal change in tenant footprints because of the ongoing work-from-home practice. But in Australia as elsewhere, "Well-located quality office assets that meet sustainability and amenity requirements will benefit from stronger tenant demand and drive bifurcation," the commentary concludes.

While the short term remains challenging, the Australian office market has stronger connections to the Asia Pacific region than to North America because of its geographical, economic and cultural ties, believes Ankur Gupta, head of Asia Pacific and Middle East for Brookfield's real estate group. A stable political environment and relatively strong economic fundamentals compared with other regions continue to make Australia an attractive destination for investors. "While national vacancy is relatively high at 14.7 percent, there is limited supply outlook, which presents an opportunity for an upswing in net effective rents in the medium term," Gupta predicts.

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challenges more effectively," the report notes. Also, landlords, especially in China, have prioritised higher occupancy rates over rental rates, which exerts downward pressure on rents.

Sales transaction volumes have remained relatively low, according to Colliers' *Q2 2024 APAC Cap Rates* report, although expected interest-rate cuts should stimulate investment activity later this year. Existing inventory and new supply have caused occupancy pressure in Hong Kong, Manila and Shanghai, while Seoul and Singapore have relatively limited supply and persistent demand.

CBRE's July *2024 Asia Pacific Real Estate Outlook Mid-Year Review* found oversupply continuing to affect the office market in the first quarter of 2024, pushing overall vacancy rates to a record high. Cost remains the dominant factor driving renewal and relocation decisions.

The flight to quality continues

Asia Pacific has its office market challenges, but one thing is clear: Prime space has weathered these tough times for office very well. In the first quarter of 2024, vacancy rates across Asia Pacific were about 7 percent for prime office space, well below the 19 percent for grade A, while prime rental performance also showed more resilience, according to CBRE's June 2024 report *Flight to Quality in the Asia Pacific Office Market.*

This flight to quality is an ongoing worldwide phenomenon. Savills' latest *Prime Office Costs* finds prime office rents 31 percent higher than grade A in 35 major global markets. Even in the United States, with its severe office problems, newer and prime, trophy-grade offices continue to enjoy high demand. According to Hines' report, the trophy-grade segment of the US office market makes up about 6.5 percent of the overall market inventory but has garnered more than 25 percent of office positive net absorption since 2000.

In Asia Pacific, the premium for prime is even higher, at 33.7 percent, according to Savills. As always, location matters, and these overall impressive numbers hide the bifurcated reality: The premium for prime space in Sydney is only 13.5 percent, while in China's Shenzhen and Beijing it exceeds 70 percent.

Importantly, Savills also found 94 percent of the top prime office occupiers globally chose to either expand or renew their current sizing, with only 6 percent shrinking their footprint.

"Premium-grade office continues to be a cornerstone of our portfolio across Asia Pacific," says Ankur Gupta, head of Asia Pacific and Middle East for Brookfield's real estate group. "There has not been a single day where we have changed our opinion on the strength and attractiveness of high-quality office."

This holds true in multiple Asia Pacific markets. In South Korea, for example, which benefits from strong office-market fundamentals and no work-from-home culture, Brookfield's office complex at IFC Seoul is at 99 percent occupancy. Offices in major metropolitan areas in Japan have been consistently strong, with vacancy rates in Tokyo and Osaka below 5.2 percent and 4.2 percent, respectively, Gupta notes. And India's favourable market fundamentals will continue to drive office investing there.

Vacancy rates in South Korea have consistently stayed around 2 percent during the past two years, with rents in Seoul's premium office buildings seeing double-digit growth in the same period, Hines' Shen adds. In Japan, the low vacancy rates for grade A office suggest likely future rental growth. "The combination of favourable currency exchange rates and attractive borrowing costs has also significantly enhanced the appeal of acquiring high-quality assets in Japan," Shen believes.

The office experience is becoming increasingly crucial, with occupiers viewing their office

spaces as more than just physical workspaces. "Office properties that are sustainable, employee-centric and adjacent to amenities are now considered strategic assets that can help companies attract and retain talent," says Shen. "We're seeing tenants further gravitating towards high-quality, sustainable office properties in core central locations across developed Asia office markets, including South Korea, Japan and Australia."

Is the waiting game over?

Emerging Trends finds office investments have been negatively affected by a bid/ask standoff. Many investors have maintained a wait-and-see approach to deploying capital in the first half of 2024, waiting for anticipated interest-rate cuts, according to CBRE's *2024 Asia Pacific Investor Intentions Survey.* Rate cuts are expected this fall, but if significant cuts are delayed until 2025, will investors continue to play the waiting game or deploy capital as motivated sellers become more flexible?

"Some investors will continue to play the waiting game, but opportunistic investors will begin to take advantage as sellers with liquidity issues and near-term debt maturities become more motivated," says Albert Behler, chairman, CEO and president of Paramount Group. "Motivated sellers will capitulate and accept larger discounts, thus reducing the bid/ask spread."

These price cuts will support deal closures without rate cuts so long as the capital markets are functioning and the cost of debt is not prohibitive, Behler believes, especially for larger assets greater than 500,000 square feet (46,452 square metres). "We have already begun to see deal activity increase among smaller assets where all-cash offers are made and owner occupiers have been motivated to sell," he observes.

The massive maturity wall and expected deep discounts

Over the next two years, owners with debt will face a massive maturity wall of nearly US$1 trillion, with a cost of capital that should be significantly higher than at origination, even with some rate cuts, Behler advises.

Between generationally high interest rates, wider credit spreads reflecting the lack of liquidity, lender aversion to office, and declining valuations that have driven up LTVs, Behler expects deep discounts on many assets over the next 12 to 24 months. He says, "Only well-capitalised investors will be able to climb the wall, while those that are not will need outside capital or their lenders will have to exit the loans at discounts." This could create "potentially the best buying opportunity of the last 50 years."

As bank lending has tightened, owners have increasingly turned to private lenders to refinance. With many senior loans set to mature, the debt opportunity is a big one: CBRE's recent *Intelligent Investment Report* predicts an Asia Pacific funding gap of US$8.4 billion between 2024 and 2026, and it will be highly concentrated in the office sector.

Value-added and opportunistic approaches

CBRE's *2024 Asia Pacific Investor Intentions Survey* finds investors favouring value-added strategies to achieve attractive returns, particularly distressed assets and real estate debt solutions to meet their goals. Industrial/logistics and office are their preferred sectors this year.

Compared with core, value-added and opportunistic strategies provide a more attractive return profile in this current higher-rate environment. "Distressed assets in the US can be acquired for the largest discounts, given a higher likelihood of additional capex needed and/or a large paydown required for refinancing," says Behler.

Five strategies for landlords

Given the ongoing flight to quality and sharp contrast in performance between prime and lesser properties, CBRE has five recommended strategies for landlords in its recent *Flight to Quality in the Asia Pacific Office Market* report:

1. **Selectively commit to new projects:** Consider them in light of the polarisation of rental performance, occupancy and tenant quality between prime and nonprime office buildings. Adopt a holistic and innovative approach towards designing future-proof buildings suited to tenants' requirements.
2. **Invest in ESG:** Invest in or develop office buildings with ESG features to align with tenants' net-zero targets.
3. **Consider asset enhancement initiatives:** Pursue upgrade features such as flex space, wellness amenities, ventilation and technology (e.g. internet infrastructure, smart lifts and touchless technology).
4. **Prioritise occupancy in aged office portfolios:** With older portfolios, prioritise occupancy rather than rents by offering attractive terms to secure tenants, especially in oversupplied markets.
5. **Consider asset conversion:** With older properties in less desirable locations, consider office conversion to multifamily, senior housing or student housing.

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With office valuations declining considerably, senior lenders are taking a much more conservative underwriting approach, especially regarding LTVs. "This will enable a new wave of opportunities for originations of mezzanine debt, preferred equity and equity, all with more attractive rates of return relative to core," suggests Behler.

But proceed with caution. Office markets vary widely and should be considered local businesses.

Five trends transforming the office market

Colliers' *Expert Insights — Asia Pacific Office Markets July 2024* report outlines five key value-creation opportunities becoming increasingly influential in corporate real estate this year. "There is a growing emphasis on flexible, high-quality workspaces that cater to evolving corporate needs. Organisations prioritising flexibility, innovation, diversification and sustainability in their real estate portfolios and workplace strategies will be a step ahead moving into 2025," the report advises. Here are Colliers' five top trends transforming the office market:

1. **Enhanced enterprise resilience:** Organisations are prioritising flexibility in their real estate portfolios and designing workplace strategies accordingly to bolster resilience against market fluctuations and adapt to evolving organisational needs.
2. **Workplace transformation for talent management:** The workplace, both physical and virtual, continues to evolve as a critical tool for attracting and retaining talent. The uptake in hybrid working models reflects shifts in organisational and societal norms towards flexible work arrangements.
3. **Artificial intelligence and data integration:** The integration of data analytics and artificial intelligence is revolutionising real estate strategies, driving efficiency across the built environment as well as optimising resource allocation and operational performance.
4. **Diversification in commercial real estate partnerships:** Companies are increasingly adopting multiple commercial real estate partner models for real estate and facilities management to enhance service delivery and operational flexibility.
5. **Sustainability-focused real estate upgrades:** There is growing momentum to upgrade legacy real estate assets and align with sustainability commitments to mitigate carbon emissions and prevent assets from becoming redundant due to regulatory changes.

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"Owner/operators with boots on the ground have a substantial advantage, as successful investing requires an assessment of local demand drivers, supply pipelines and vacancy rates, and these vary significantly from submarket to submarket within a particular CBD," Behler emphasises.

In addition, vertically integrated owner/operators focused on trophy and grade A assets with scale and with strong local relationships in capital markets and the brokerage community will be best positioned to generate outsized returns for investors.

"The US office market for these class A assets will be coming back strong," adds Behler. "The demand for this space is picking up, and no significant development has happened for quite some time. Looking back 10 years from now, the 2024 to 2026 vintages will have developed to the best vintages of decades."

Brown to green upgrades

While prime shines, there is little lustre to older and secondary assets. "Secondary office in a less desirable location without sufficient amenity has struggled in the current market across the region," notes Brookfield's Gupta. This can present opportunities for redevelopment with the right capital and strategy. "Investors should be aware of the risks, though, and pick the right organisation to partner with on these projects," Gupta cautions.

A significant proportion of office space in developed Asia is ageing — this is particularly true in Tokyo, where a huge amount of stock was built more than 35 years ago. "This presents opportunities for value-added investments, such as refurbishing older or undermanaged offices in well-located submarkets," Hines' Shen recommends.

Local expertise plays a crucial role in generating alpha, and sustainability remains a key element in value creation. For example, in 2022 Hines acquired Westgate Tower in Seoul through an off-market transaction. The Hines in-country team executed renovations, including refurbishing common areas, modernising the lobby design and adding a café. "Sustainability played a key role in the renovations and contributed to value creation," says Shen. Energy and water efficiency measures resulted in operational cost savings while contributing to decarbonisation goals.

In addition, tenant engagement was prioritised, exemplified by the renovation of the rooftop garden as a space for tenant wellness. "As a result of these efforts, the building achieved nearly full occupancy within a year of acquisition, accompanied by higher rents," notes Shen. In February 2024, Westgate Tower received LEED Gold certification following the renovations.

"Looking ahead, we believe there will be opportunities for 'brown to green' upgrades across the

region," says Shen. However, these differ widely by location and deep in-market knowledge, and experience will be important for success, notes Shen.

Best office markets

Japan remains Asia Pacific's most active market for global investors, with Singapore also popular, according to JLL's *Asia Pacific Office Tracker Q2 2024*. Japan has been an outlier in keeping interest rates low — even after raising rates twice this year, the only increases since 2007. Investment demand for Tokyo and Osaka office assets is robust. And compared with a year ago, the total return profile of Tokyo office has improved, as rental growth will drive capital value appreciation while income yields remain stable, notes JLL.

Japan continues to capture the attention of global investors, who closely monitor possible interest-rate hikes by the Bank of Japan, according to Shen. "The Japanese yen has been trading at low levels and has presented an appealing entry opportunity for global investors," he says. There has also been an increase in leasing demand in Tokyo in the past 12 months, reflecting improving health in corporate Japan. "We believe we are in the early stages of an upward trend in rent," Shen adds.

Gupta agrees, looking at Tokyo and Osaka. "The vacancies seem to have peaked out in both markets, and we are starting to see demand outstrip supply, which we expect will lead to some moderate rent growth," Gupta predicts.

"On the capital market side, we have seen a number of large-sized deals arising from carve-out and capital recycling demands, which indicates the presence of a strong bank market and ample dry powder available in the market," Gupta adds. Notably, Japan is one of the few markets in the developed world not to have distressed office transactions happening now.

The office sector in Singapore has been resilient and healthy, with core assets being tightly held. "We see compelling value-added opportunities in older, under-rented or undermanaged buildings in good locations," says Shen.

South Korea continues to be one of the world's strongest office markets, Shen believes. "In Seoul, office vacancies remain low, with strong rental growth driven by healthy demand," he says.

India's office market is also proving strong and resilient. Brookfield is one of the largest foreign real estate investors in India, including in office spaces and business parks in key gateway cities. It also sponsors and manages Brookfield India Real Estate Trust, India's only 100 percent institutionally managed office REIT.

India will continue to dominate the global services sector due to its dual advantage of high talent availability and significant cost arbitrage, Gupta believes. "Large corporations continue to enter India to set up their capability centres, and this trend will continue to drive favourable fundamentals for office investing," he says. Investors can invest in this theme through India office REITs or participation in private real estate funds that have exposure to India office.

CBRE's *Asia Pacific Office Trends Q2 2024* finds upbeat market sentiment in India, with 2023's 64 million square feet (6 million square metres) of gross absorption not far off 2019's record highs. "Momentum has remained strong in the new year, backed by India's huge talent base and buoyant offshoring and outsourcing industry," the report notes.

Today's elevated inflation and rising construction costs, along with higher interest rates and borrowing costs, promise likely future rental growth for office assets in developed Asian markets.

Better days ahead

The higher-for-longer interest-rate environment has several implications for investors. "With elevated interest rates, there will be a heightened emphasis on alpha generation and income growth as the key drivers of performance," Shen says. Deep local expertise will be crucial in identifying the right opportunities, accessing attractive deals and creating value at the individual asset level.

Today's elevated inflation and rising construction costs, along with higher interest rates and borrowing costs, promise likely future rental growth for office assets in developed Asian markets. Hines' research has found a strong historical correlation between prolonged inflation and rental growth across global markets, with an even stronger correlation in developed Asia. The rising construction costs have curtailed the pipeline of new supply, further supporting the case for favourable long-term rental dynamics.

"We are seeing favourable pricing, strong long-term rental growth, attractive currency exchange rates and tight liquidity as opportunities to put fresh capital to work," Shen says. And Hines' research also shows that historically, strong fund vintages have occurred during periods when valuations are still correcting, as they are now.

All this means savvy investors could be bound for glory as they find good office deals in the months and years ahead. ❖

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