

Seoul determination

Opportunities amidst political turmoil in South Korea's office market

by Kyung W Paik and Kang Min Ryu

South Korea has long been considered an important player in the global economy, and its capital, Seoul, is now one of the largest cities in the world. The country has experienced tremendous growth since the armistice of the Korean War in 1953, becoming the 11th largest economy in the world and the third largest in Asia over time, according to the International Monetary Fund. The Bank of Korea indicates GDP per capita grew from US\$131 in 1966 to US\$27,560 in 2016, an 11.5 percent average annual growth rate over the span of 50 years. Today, Seoul is one of the most dynamic cities in Asia, ranking fourth in the world by GDP after Tokyo, New York City and Los Angeles, according to CBRE Research, and Seoul's office market is the second largest in Asia, behind Tokyo.



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In spite of South Korea's history of growth and track record of strong economic gains, the country often has been in the headlines for less-positive reasons, most recently internal and external political uncertainties. To adequately assess where the South Korean market stands today, it is important for real estate investors to understand the parameters and magnitude of actual risks in the region. In fact, seasoned investors who can see beyond the recent noise should find compelling investment opportunities in South Korea, provided they have the skill set to execute on dynamic business plans.

Political uncertainty in 2016–2017

Although South Korea is accustomed to the geopolitical risks that have surrounded the peninsula for more than six decades, the presidential political scandal and renewed North Korean provocations in 2016 and 2017 have undoubtedly stirred the country more profoundly than most previous events.

The presidential scandal unfolded in October 2016, when news broke that a female confidante of now-former President Park Geun-Hye had used her connections to the president to influence government policy and extort vast sums of money from major South Korean conglomerates. President Park denied any wrongdoing or involvement in the acts of her friend, which provoked public outcry. In December, the National Assembly of the Republic of Korea voted for the president's impeachment and, on 10 March 2017, the Constitutional Court of Korea unanimously upheld the decision. A new presidential election was held 9 May, and liberal candidate Moon Jae-In was elected president, effective immediately. The Moon presidency should usher in a period of greater political stability and potentially a new approach to North Korea, involving more engagement than was seen under Park.

In addition to the tumultuous domestic political scene, North Korea repeatedly provoked military tension last year in reaction to South Korea's hard-line policy toward the country. North Korea conducted two nuclear tests and 22 ballistic missile tests between January and October 2016. In retaliation for these tests, South Korea shut down the Kaesong Industrial Complex, which was maintained as an economic cooperative zone between the two Koreas, and agreed with the United States to deploy the THAAD (Terminal High-Altitude Area Defence) missile system to the Korean Peninsula as a defensive measure against the threats of North Korea. As a result of the THAAD installation in close proximity to China, diplomatic tensions between South Korea and China have heightened, and the Chinese government has taken retaliatory actions, including government-sanctioned trade boycotts. These measures have tempered economic growth in South Korea, but the impact has been limited.

Limited effect on the Korean economy

Notwithstanding the aforementioned political friction, the South Korean economy has continued to grow consistently. The Korean Composite Stock Price Index (KOSPI) rose 3.3 percent year-over-year in 2016, and foreign investors' net stock purchases reached US\$9.8 billion, the greatest sum since 2012. As at 29 May 2017, at a time when tensions between North Korea and the United States were near their highest, the index was

up 16 percent year-to-date and had reached historical highs, which can be attributed to investors' confidence in South Korea. The economy has grown at a stable 2.8 percent for two consecutive years, while the unemployment rate is 3.7 percent, remaining at what the Bank of Korea considers a quite healthy level. Foreign-tourist arrivals were expected to decline after mid-2016 because of the nation's increasing tensions with China but, by year's end, the number of tourists exceeded 17 million, a 30 percent increase over 2015, according to the Korea Tourism Organisation.



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So why is South Korea thriving amidst concerns from other countries about a possible war with North Korea? Despite North Korea's posturing, many political experts believe North Korea and its adversaries are unlikely to engage in any military action because the main actors in any military conflict (ie, South Korea, United States, China, Japan and Russia) want the region to remain stable and secure, and they are seeking a "denuclearisation" of North Korea, not necessarily a regime change. Most believe this goal should be achieved through pressure (ie, sanctions) and negotiations, and not by military action. The North Korean regime under Kim Jong-Un may seem malicious, but it is not believed by many observers to be irrational enough to ultimately cross the line, given an outright war may end the regime. Military threats by North Korea are nothing new in

the region and are widely considered to be merely a means to gain diplomatic advantages and, thus, the impact on the South Korean economy has been, and is expected to continue to be, limited. Investors who are able to look beyond political noise and focus instead on strong investment opportunities can be rewarded with favourable risk-adjusted returns.

Robust office market

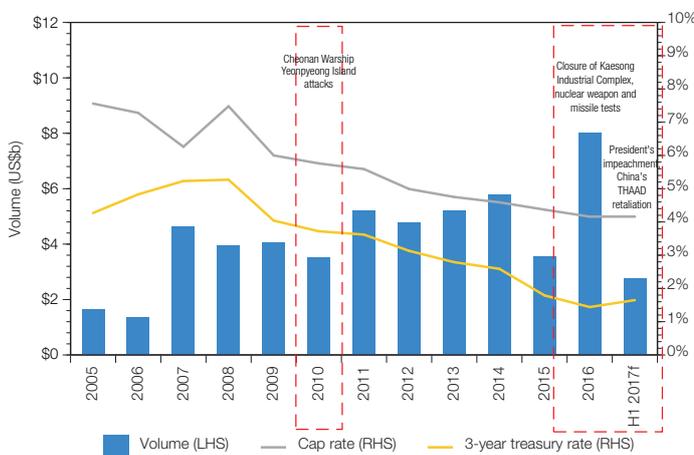
Similar to the broader South Korean economy, the Seoul office market thus far has shown no signs of any negative effect. The vacancy rate for prime-grade offices — which had been increasing since 2010 due to oversupply — has been stabilising from positive absorption since 2015. In the past, demand for Seoul office was traditionally from manufacturers and financial companies, but recently demand has been diversifying to include start-ups, IT companies and the service sector. In addition, landlords of newly-built prime-grade offices are aggressively providing incentives such as rent abatement and tenant improvements, attracting tenants that are upgrading, expanding or consolidating from grade B or grade C offices.

The Seoul office market historically has been among the most established in major Asian cities in terms of market liquidity and investment return. Because of increased investment from both foreign and domestic investors, the Seoul office market reached a record-high transaction volume of US\$8 billion in 2016, of which a staggering 47 percent involved foreign investors, a significant increase over the 25 percent share represented by foreign investors in 2015, according to IGIS Asset Management Co. As shown in the chart to the left, historical Seoul office transaction volume and cap rate trends seem to have suffered no impact from North Korea-related political events. Cap rate spreads against Treasuries are a healthy 210 basis points, higher than in most other Asian cities.

Investor activity: mismatch between capital and opportunity

Traditionally, South Korea has been a market where the potential for outsized returns arises because of the mismatch between capital preferences and available investment opportunities. Distressed and value-add real estate opportunities are increasing as traditional industries, such as shipbuilding, construction and manufacturing, experience sluggish growth, and the government is placing increasing pressure on financial institutions to restructure their balance sheets. Domestic investors, who are conservative by nature and traditionally have invested mainly in stabilised core assets, have not been active in distressed and value-add investment opportunities, whereas foreign investors, who have been more flexible in their investment approach, have taken advantage of this less-competitive space. As shown in the table on page 8, domestic investors primarily invested in stabilised core assets in 2016, while foreign investors mainly invested higher up the risk curve.

Seoul office transaction volume, cap rate and Treasury rate, 2005–H1 2017f



Sources: IGIS Asset Management Co (transaction volume), Savills Korea (cap rate), Bank of Korea (Treasury rate)

Structural and cyclical opportunities

Various structural factors — dominant property ownership by local conglomerates, supply characteristics of the Seoul office market, and the mismatch in the capital markets — should result in a flow of value-add investment opportunities in the future.

Domestic conglomerates and large corporations are still the dominant owners in the Seoul office market, as compared with other major office markets in developed countries. Thus, only about 30 percent of the office inventory larger than 5,000 pyeong (approximately 16,500 square metres) is owned by institutional investors, according to IGIS. Headwinds faced by traditional manufacturing companies and the declining desire by conglomerates to hold real estate on their balance sheets have driven the opportunity for distressed sales by these companies. Such investment opportunities are dominated by foreign investors rather than by domestic institutions, however, which have more stringent investment guidelines and a much more conservative approach toward distressed opportunities.

The lack of quality office space creates an opportunity to deliver new or refurbished product to meet tenants' demands. More than half of the total Seoul office supply is more than 20 years old and rapidly becoming obsolete; investible grade A stock makes up less than 15 percent of total inventory, notes IGIS. Tenants that value quality space and services are migrating to new or refurbished buildings, and a compelling case can be made to renovate grade B offices into grade A stock to take advantage of these leasing-market dynamics. New supply between 2017 and 2020 is expected to be approximately 20 percent higher than the average supply over the past five years, but most of that is expected to be concentrated in the Yeouido Business District, Seoul's financial district. As such,

vacancy rates are expected to remain fairly stable in the CBD and Gangnam Business District over the next three to five years, according to IGIS. A compelling opportunity exists for investors to take advantage of the market recovery through forward purchases that limit leasing risk.

The “buy-fix-sell” strategy employed by foreign investors should become even more prevalent because of the difference in investment appetite between domestic and foreign investors. Potential value-add investors can buy at 15 percent to 20 percent discounts, compared with the price of a stabilised core asset. A ready and highly-competitive domestic market for stabilised assets exists, once investors successfully execute their value-add business plans. The key factor underlying a successful value-add investment is to have the network to discover these opportunities and an on-the-ground team to execute the business plan.

The bottom line

South Korea historically has been, and should continue to be, an attractive place for investors who can see beyond widespread misperceptions about the political environment in the country. Well-informed investors can find hidden gems at a time when seeking high risk-adjusted returns in other regions of the globe has become ever more challenging.

Value-add opportunities offer compelling risk-adjusted returns in the market, given the disparity in pricing between transitional and stabilised assets, but strong on-the-ground execution capabilities are critical to success in implementing this strategy. ♦

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Major Seoul office transactions, 2016					
Investment strategy	Transactions	Seller profile	Buyer	Buyer profile	Transaction price (US\$m)
Core	West Gate Tower	Fund	Hyundai Investment	Domestic	\$136
	Nara Building	Foreign fund	Koramco	Domestic	\$189
	Limgwang Building	REIT	NH Life	Domestic	\$286
	Time Square	Fund	NH Amundi	Domestic	\$176
	Centre Point Gwanghwamun	REIT	Koramco	Domestic	\$279
Core-plus	STX Namsan Tower	REIT	LG	Domestic	\$272
	Capital Tower	Fund	Blackstone	Foreign	\$424
	IFC (office only)	Fund	Brookfield	Foreign	\$1,680
Value-add	Taepyeong-ro Building	Insurance co	IGIS	Domestic	\$209
	Samsung Life HQ	Insurance co	Booyoung	Domestic	\$520
	Jong-ro Tower	Insurance co	IGIS + Alpha	Foreign	\$349
	Prime Tower	Fund	AEW	Foreign	\$155
	Samsung Finance Plaza	Fund	AEW	Foreign	\$137
	DSME Building	Corporate	Orion Partners	Foreign	\$155
	T Tower	Fund	IGIS + PGIM	Foreign	\$172
Opportunistic	Sindorim Mirae Tower	Fund	IGIS + Angelo Gordon	Foreign	\$61

Note: US\$1 = KRW 1,100. Transactions in which the buyer was a foreign investor are highlighted in orange. Source: IGIS Asset Management Co

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