Despite this, however, flows of foreign capital into the Philippines have yet to gain traction, mainly because local asset markets are already overflowing with cheap domestic capital also looking for an investment home. What are the consequences for both local and foreign investors? At a ULI Capital Markets Forum event held in Manila in January—sponsored by Primeiro Partners and ATR Asset Management—19 prominent developers, asset managers, and brokers gathered to discuss this and other issues relating to local markets.

One feature that markets in the Philippines have in common with others in Asia is that the booming domestic economy has generated huge stockpiles of liquid capital that have now outgrown the capacity of local asset classes to absorb. The corporate bond market remains tiny (just US$15 billion in outstanding issues), sovereign bonds yield next to nothing, and equity markets are both narrowly focused and undercapitalised.

As a result, local institutional investors are increasingly looking to place their capital in real estate, an asset class that offers higher yields and durations better matched to their own long-term liabilities. According to one Manila-based asset manager, “If
you add it all up, there’s about 6 trillion pesos [US$115 billion] in assets under management today, with very little direct property exposure. In addition, there’s another 11 trillion [US$210 billion] sitting in banks, a lot of which would cross over to asset management if there were enough products and yield to go after.”

The problem, as in other parts of Asia, is that this flood of new capital has now made real estate in the Philippines a very crowded trade, especially in markets already dominated by the two big incumbents, AyalaLand and SM Prime Holdings.

The result, as one asset manager put it, is that “the investor base in the Philippines, which is primarily institutional, is starving for opportunity to invest.”
NICHE ASSET CLASSES

Competition to place this capital is now forcing liquidity into various niche or unconventional asset classes. The debt market is one example. While bank lending has long been the go-to source of financing in the Philippines, investors are now exploring securitisation as a model, looking in particular at bundling and reselling mortgages held by larger developers, as well as the real estate portfolios of local banks, which by law may not exceed more than 20 per cent of total lending.

However, while the lack of a local real estate investment trust (REIT) sector has probably served to boost the evolution of a market for commercial mortgage-backed securities (CMBS), securitisation remains problematic given the lack of a regulatory framework, bank reluctance to divest their better-quality loans, and the legacy left by the meltdown of the American securitisation market during the global financial crisis. Progress is therefore likely to be slow.

Infrastructure investments are another possible investment outlet. The Philippines in general remains woefully underequipped in terms of infrastructure, especially in the distribution and industrial sectors that have now become important engines for economic growth. As one participant put it, “We can open the gates, but if we haven’t even built the road to the gate, what’s the point?”

The Duterte government recently embarked on a decade-long, US$180 billion infrastructure spending spree, providing plenty of opportunity for new investment. Areas just outside Metro Manila, such as the Clark Freeport Zone and Subic Bay, for example, have long been earmarked for development as the inner city fills up, but are in urgent need of transportation and other facilities to allow this to happen.

That said, margins on infrastructure investment remain slim given aggressive lending terms offered by local banks. In addition, the bureaucracy is often stifling, leading to long delays in project completion. Opportunities in this sector, therefore, may prove to be limited.

PROVINCIAL INVESTMENTS

Another option is for investors to migrate to areas outside Manila. Local developer DoubleDragon, for example, has built an extensive portfolio of community malls in second- and third-tier cities. Designs are standardised, with each facility about a tenth the size of a typical large-scale mall.

“It’s like a fast-food branch,” one developer said. “They build it in about eight months, and one-third is grocery. Each one looks exactly the same, but your menu items are the typical brands — all basic necessities. It’s not the type of stuff you would buy online, for example, so it’s very e-commerce-defensive.” Many of the stores and products on offer are owned by large conglomerates, which are also partners in the project.

The community mall concept is partly demand driven, but the idea is also a function of supply-side conditions because big cities are now saturated with product, leaving provincial locations as the only options for retailer expansion. This template seems a plausible model for investments in other developing markets, too.

FOREIGN INVESTMENT

Over the past few years, high yields, good growth prospects and a compelling demographic story have piqued interest in Philippine assets among foreign fund managers.

More recently, however, appetite appears to have tailed off. In ULI/PwC’s most recent Emerging Trends in Real Estate Asia Pacific report published last December, the ranking for Manila’s investment prospects slipped to 18th out of 22 regional cities, down from a high of third the previous year.

Foreign investor interest has dipped for a number of reasons:

- Banks continue to hold huge amounts of capital, making the cost of debt very low. Foreign private equity funds with high-teens or low-20s hurdle rates find it hard to compete when local banks are offering loans for the same deal at 2.75 per cent.
Regulatory restrictions limit foreign equity interests in local property assets to a maximum of 40 per cent. Several forum participants identified this as the single biggest deterrent to foreign investment in Philippines real estate.

Domestic markets are controlled by a handful of big players who generally have no need for expensive foreign capital.

Good partners are otherwise thin on the ground and are anyway often slow to react to emerging opportunities.

A number of rich families hold land banks that in principle would be ideal for development, but they generally lack experience in navigating real estate projects and are therefore slow to commit.

“As a foreign investor, you could either buy property stock or invest directly, but it’s going to be tough,” said one local developer. “You have to go into another market, get comfortable with a local player, forge that partnership. It’s not going to happen overnight, and there really aren’t too many options.”

NO TAX BREAK FOR REITS
As in other markets, the most obvious way to provide more investable assets for both local and foreign buyers would be the creation of a domestic REIT sector. For the foreseeable future, however, this option seems to be on hold. REIT implementing rules and regulations were introduced by government regulators a few years ago, but they make REIT structures unattractive to the real estate industry; as a result, no REIT listings have taken place.

The problem is one of image rather than fundamentals. As one forum participant observed, “On the one hand, the government is trying to increase its income because they have so many new obligations to fund, whether it’s infrastructure or social services. On the other, the perception is that REITs are just tax breaks for rich developers, most of which are family owned. So the Department of Finance is struggling to find a structure the public will [accept].”

There was no doubt among participants, however, that REITs would provide not only an avenue for currently unallocated capital to be put to work, but also greater efficiency in capital allocation.
“REITs allow more economic activity, more investment, and more entrepreneurship,” one investor said. “There are a lot of stranded assets here in the Philippines that are family owned or trust owned and have no way to be monetised because capital is not flowing fast enough. The people that have capital are thinking about other and bigger things. The REITs would help because they allow you to amalgamate a number of assets and start monetising them through the public markets, which, by the way, are dying for yield.”

DEALS ARE HAPPENING
Notwithstanding these constraints, several participants suggested that local developers are now becoming increasingly willing to partner with foreigners, and saw signs that the flow of internationally sponsored deals is beginning to pick up.

“There is money coming into the Philippines, and there are legal, profitable ways to set up shop for foreign investors,” one locally based broker said. “It’s not easy and it’s not with tier-one developers, but even in very difficult real estate investments, there are now opportunities for people who are ready to work with local partners.” In particular, several recent large transactions have featured Japanese companies working in conjunction with prominent local players.

Historically, foreign investors have been more likely to feature in deals involving the business process outsourcing (BPO) sector, where tenants are usually foreigners. But growth in this sector has recently levelled off as automation and artificial intelligence (AI) technology have begun to eat into what is now a maturing industry. Going forward, therefore, the stellar growth that local and global BPO markets have enjoyed will probably begin to slow.

“The general consensus is that over time, certain tasks and job functions will disappear,” said one developer active in the industry. “So the regular job of the call centre agent who just picks up the phone and does simple customer support – that job will probably not exist in ten to 20 years’ time.”

While the BPO sector will necessarily adapt – by way of increased specialisation, for example – and the AI industry will itself
generate a certain amount of employment, the future here remains opaque. The only certainty now is that these new technologies will be less labour intensive than their predecessors.

Otherwise, debt financing is another area now getting attention from foreign investors. One Manila-based broker referred to at least three international investment funds currently looking at this area, in particular by providing mezzanine funds to supplement in-house financing strategies of developers involved in low-rise housing projects.

UNCONVENTIONAL ASSET CLASSES
Perhaps the most fruitful—but also more risk—option for foreign funds is to invest in either unconventional asset classes or in projects that allow them to leverage operational expertise to justify their higher cost of capital.

One investor mentioned a growing opportunity in worker dormitories, which have become increasingly popular in Manila as traffic problems worsen and daily commutes lengthen. Yields offered are supposedly comparable to those of conventional office assets.

Another investor identified industrial parks and logistics as areas where foreign capital may have an edge. “As we began diversifying out of Metro Manila and into the industrial/logistics space, we started looking at investors on a more strategic basis,” the investor said. “So, for example, where foreign funds had relationships with global manufacturing firms or retail coming from China to the Philippines, they could provide not only the capital, but also the tenants. That allowed us to de-risk not just the development or the capital side, but also the tenant portion.”

As developers become more specialised and sophisticated in their approach to new projects, the advantages of foreign expertise are likely to become increasingly evident.

A final, related, area that may prove fruitful for international investors involves construction of “new industry cities”—large-scale greenfield developments built in partnership with the government on a public/private partnership basis. At least one large Mainland Chinese developer is looking at transplanting to the Philippines the well-established Chinese model involving creation of mixed-use integrated developments anchored by a large industrial or business park.

Some participants were ambivalent about this model, however. While infrastructure-oriented investment is more likely to escape the impact of Chinese government controls on outgoing capital because of its connection to China’s Belt and Road Initiative, negotiations with Philippine authorities have yet to bear fruit. Some doubt an agreement will ever be reached, partly because Chinese developers may be unwilling to accept a 40 per cent limit on equity ownership, and partly because lack of suitable land means such facilities will probably be consigned to unfavourable locations far from city centres.

Still, the mere fact that so many new opportunities to invest are beginning to open up in the Philippines bodes well for the future: as local asset markets continue to mature, they provide both opportunity and incentives for sophisticated investors to participate.
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