



PETER CLARKE

Emerging Trends in Real Estate®

Asia Pacific 2016



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Institute**



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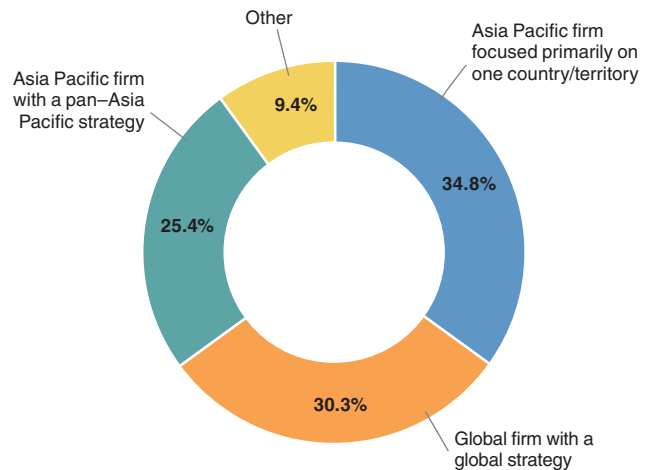
Executive Summary

Asia's real estate markets are the product of almost eight years of easy money from the world's central banks. Easing in the United States may have ended, but both Japan and the European Union continue to provide liquidity, while interest rates in many Asian countries are now lower than they were a year ago. With both local and global institutional investors also allocating more capital to the sector, the result is more money chasing fewer assets, pushing prices up across most markets and sectors even as the current cycle appears increasingly long in the tooth.

The main takeaways from this year's *Emerging Trends* research include the following:

- Weak transactional activity in the first half of the year was attributed mainly to slower sales in China. While some international investors remain cautious about the mainland, transactions across the region picked up strongly in the second half and are now expected to match or exceed last year's record levels.
- Yields are also pushing record heights in most markets, but buying momentum seems unlikely to slow in 2016. As a result, although a few investors see current pricing as a high-water mark, the majority believe the growing weight of capital will continue to push prices up and yields down, albeit at a slowing pace. Meanwhile, investors increasingly are opting to take profits, exiting deals made in the years after the global financial crisis.
- With yields in Asia now at levels often deemed uncompetitive compared with deals on offer in the United States and Europe, some investors continue to move up the risk curve, investing in asset classes and geographies that provide better returns. At the same time, this trend has probably slowed since last year. Investors with an eye on a possible peak in the cycle are more likely to gravitate toward the safety of core assets in gateway cities.
- Although yields may have further to run in markets such as Australia and Japan, many investors now see rental growth (rather than cap-rate compression) as a source of future profits. This is a controversial notion, however. While the cycles in both countries are at a point where rent increases are plausible, other investors see such expectations as rationalizations.
- Opportunistic returns are tough to find in the current environment, but plenty of funds operate—apparently profitably—in the space. The best venues for opportunistic returns currently are Japan (where cheap debt and high leverage provide scope to financially engineer oversized

Survey Responses by Geographic Scope of Firm



Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

profits) and China (where developers are strapped for cash, liquidity is in short supply, and the slowing economy is scaring away other potential sources of capital). Opportunities for distress, meanwhile, remain elusive, with the possible exceptions of China and India.

- As more institutional investors crowd into Asian markets, the need to find ways to invest large sums of capital is leading to a proliferation of mergers and acquisitions and portfolio-type deals.
- Emerging markets such as the Philippines, Vietnam, and Indonesia have enduring appeal given the higher yields and growth they offer. But most investors are steering clear in practice given the heightened levels of risk in the current environment, with high exchange rate and capital flow volatility as the United States heads toward an impending hike in the base rate.
- There is plenty of risk out there, but the most commonly mentioned scenarios involved faster-than-expected increases in interest rates, and—a perennial favorite—a hard landing in China with a knock-on effect across the rest of Asia.

In terms of capital flows, this year has seen a cash migration from Asia to other parts of the world that surpasses even last year's record levels. Nor is this exodus set to slow. Most investors see only continuing increases in capital movements to real estate markets in the West, with one calling it "one of the biggest stories in our industry."

The main contributor to this trend is China, where institutional, corporate, and private capital is buying (within Asia) mainly in Australia and Japan, and (outside Asia) mainly in the United States. Singapore also is a major exporter of capital. The huge amounts of money now headed to the United States are a reversal of last year's outflows, which were more focused on Europe, and in particular London. The United States is now favored partly because of anticipated currency appreciation and partly because the European distress story has largely played out.

On the banking front, there is still plenty of liquidity to fund property investments. Borrowing terms in most jurisdictions remain largely unchanged in the face of impending interest rate rises, with the possible exception of Hong Kong and Singapore. Japan remains the easiest market in which to raise debt, with borrowing easily available at rates of less than 1 percent. International banks are now increasingly active in Asia, offering longer tenor than the traditional three- to five-year terms.

In the capital markets, bond financing remains widely available and has become arguably the number-one option for Chinese developers to raise capital, usually by way of domestic issues, which are now significantly cheaper than foreign-currency debt issued on regional stock markets (usually in Hong Kong).

Regional real estate investment trust (REIT) markets have declined somewhat from last year's highs as expectations of higher interest rates dim the appeal of investments that trade similarly to bonds. Nonetheless, regional REIT indices remain at elevated levels compared with where they were trading several years ago. Moves are afoot to develop REIT markets

in various emerging markets, with some progress toward that goal made in India and China, although realistically functioning REIT markets in these countries remain some way off. The Philippines may make more progress on this front should the government change following upcoming general elections.

This year's Investment Prospects survey reflects an overwhelming preference among investors to buy in the region's most developed markets—Japan and Australia. Tokyo's top ranking in 2016 completes a hat trick of wins for the city over the last three years. Osaka, Sydney, and Melbourne occupy the remaining top four places, underscoring investors' quest for asset quality and yield.

Other major survey findings include continuing caution about investing in China, with concern centered on an array of issues ranging from a soft economy, a depreciating currency, oversupply, and compressed cap rates. Shanghai is the one market where investors remain more positive, reflecting its status as China's only true gateway city where prime assets will always be in demand.

The industrial/logistics sector, meanwhile, continues to be highly favored on the basis of better-than-average cap rates, tied with what is likely to be long-term structural undersupply.

Notice to Readers

Emerging Trends in Real Estate® Asia Pacific is a trends and forecast publication now in its tenth edition, and is one of the most highly regarded and widely read forecast reports in the real estate industry. *Emerging Trends in Real Estate® Asia Pacific 2016*, undertaken jointly by PwC and the Urban Land Institute, provides an outlook on real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues throughout the Asia Pacific region.

Emerging Trends in Real Estate® Asia Pacific 2016 reflects the views of 343 individuals who completed surveys or were interviewed as a part of the research process for this report. The views expressed herein, including all comments appearing in quotes, are obtained exclusively from these surveys and interviews and do not express the opinions of either PwC or ULI. Interviewees and survey participants represent a wide range of industry experts, including investors, fund managers, developers, property companies, lenders, brokers, advisers, and consultants. ULI and PwC researchers personally interviewed 99 individuals, and survey responses were received from 244 individuals, whose company affiliations are broken down as follows:

Real estate service firm.....	26.2%
Private property company or developer.....	25.4%
Institutional/equity investor or investment manager.....	20.9%
Equity REIT or publicly listed property company.....	8.6%
Bank, lender, or securitized lender.....	4.1%
Private REIT or nontraded real estate property company.....	2.5%
Homebuilder or residential land developer.....	1.6%
Mortgage REIT or real estate debt investor.....	0.4%
Other entities.....	10.2%

Throughout the publication, the views of interviewees and/or survey respondents have been presented as direct quotations from the participants without attribution to any particular participant. A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PwC extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.

Through the Looking Glass

“It’s always a sign, and we’re seeing it now—people are beginning to rationalize, to look at things in a more generous fashion than they did. It reflects the pressure these funds are under to invest and to deliver.”

As the bull market in Asian real estate enters its seventh year, both pricing and yields continue to tighten across most markets, creating a feel-good factor for many fund managers as they look to sell assets purchased years ago in the wake of the global financial crisis. However, while that gambit has now proved a profitable trade, the outlook for more recent purchases seems less of a sure thing. Regional economies are generally weak, exports are down, and currencies are depreciating. On top of that, today’s ultra-compressed yields have taken prices to rarefied levels, suggesting we may be approaching a cyclical peak.

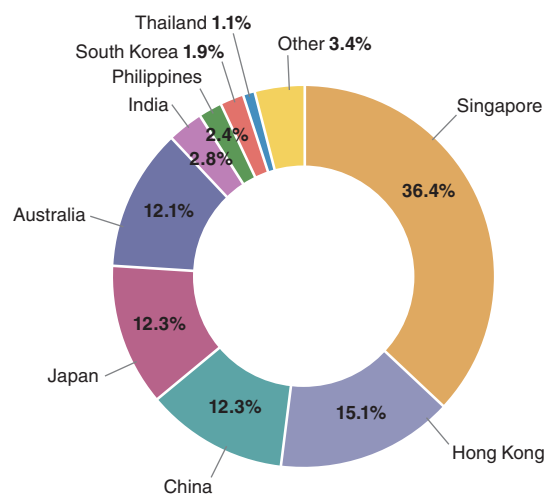
The problem with the end-of-cycle theory, however, is that indicators on the ground continue to suggest otherwise, as a tide of new money compresses cap rates ever tighter across the region. As one fund manager commented: “It’s a difficult environment in which to deploy capital. There’s no low-hanging fruit. There are no particularly obvious trades. I struggle with it, and if you try to put normal assumptions around acquisitions, it’s pretty hard to make them make sense in most markets.”

It is this apparent contradiction that characterizes the current situation, even as prices continue to grind higher and risks at the macrolevel grow. What’s more, this contradiction creates issues in itself, because the danger in trying to make sense of irrational markets is that investors begin to rationalize. In the words of a manager at a large institutional fund: “My fear is that institutions will get impatient and investment committees [will] put pressure on teams to put money out. As a result, things become sketchy in the underwriting. They convince themselves rents will grow at certain rates, or cap rates will come down more. And that has all the ingredients for leading markets into dangerous areas.”

Transactions Stronger Than They Seem

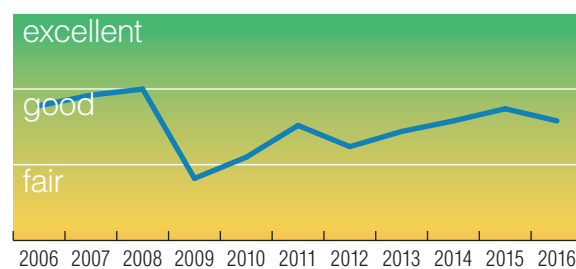
While overall demand may be rising, transaction volumes for the first half of 2015 were soft, with sales of commercial

Exhibit 1-1 Survey Responses by Country/Territory



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Exhibit 1-2 Real Estate Firm Profitability Trends

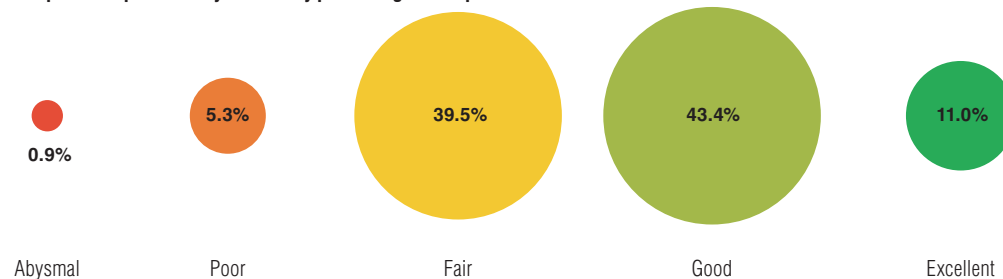


Source: *Emerging Trends in Real Estate Asia Pacific surveys.*

property falling as much as 41 percent year-on-year in U.S. dollar terms, according to data providers Real Capital Analytics (RCA).

Exhibit 1-3 Firm Profitability Forecast for 2016

Prospects for profitability in 2016 by percentage of respondents



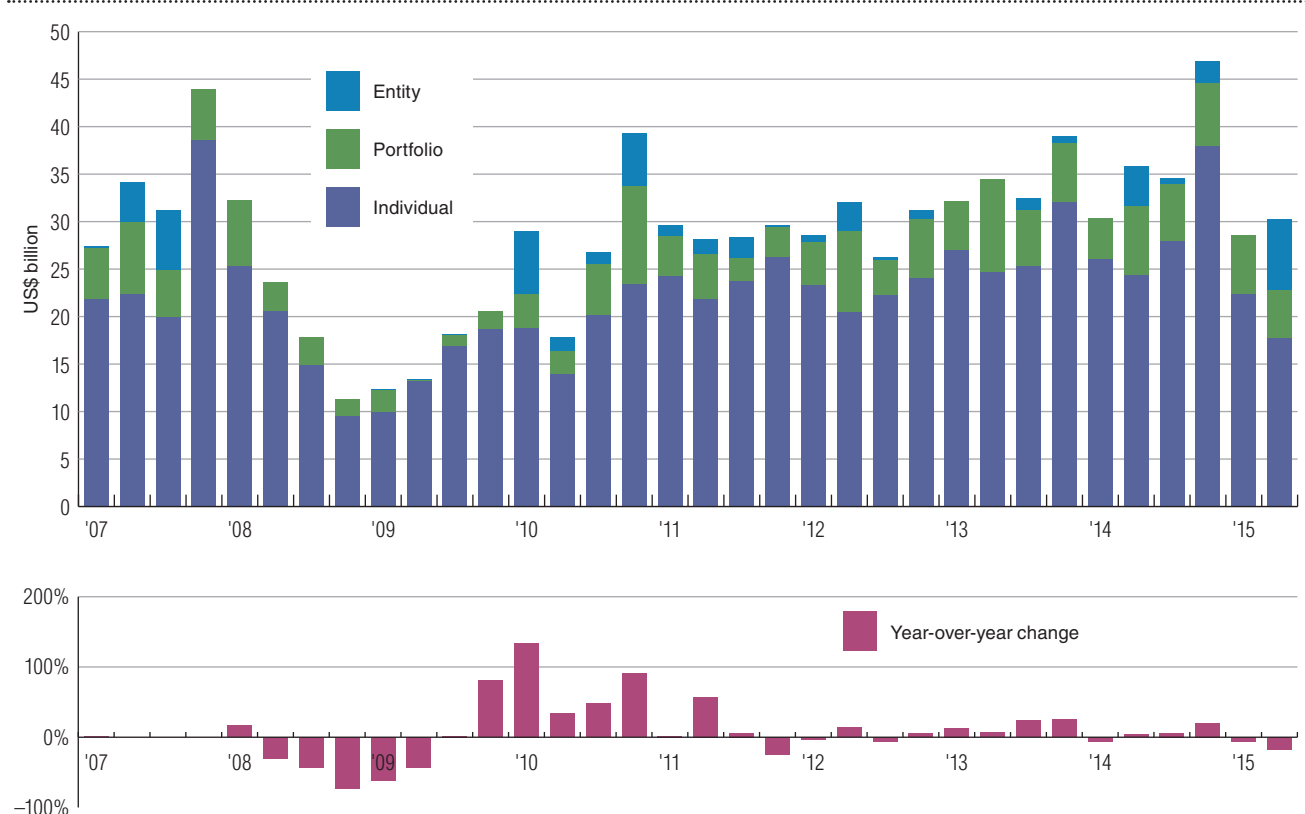
Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

That figure is a bit misleading, however. For one, a big part of the decline relates to falling sales of land in China, where a glut of inventory in secondary cities has removed incentives for developers to replenish land banks. Once that is stripped out, the number drops to just 13 percent, according to RCA, of which about half is attributable to regional currency depreciation against the U.S. dollar.

First-half figures are therefore more comparable to last year's record-breaking performance than they appear, with the

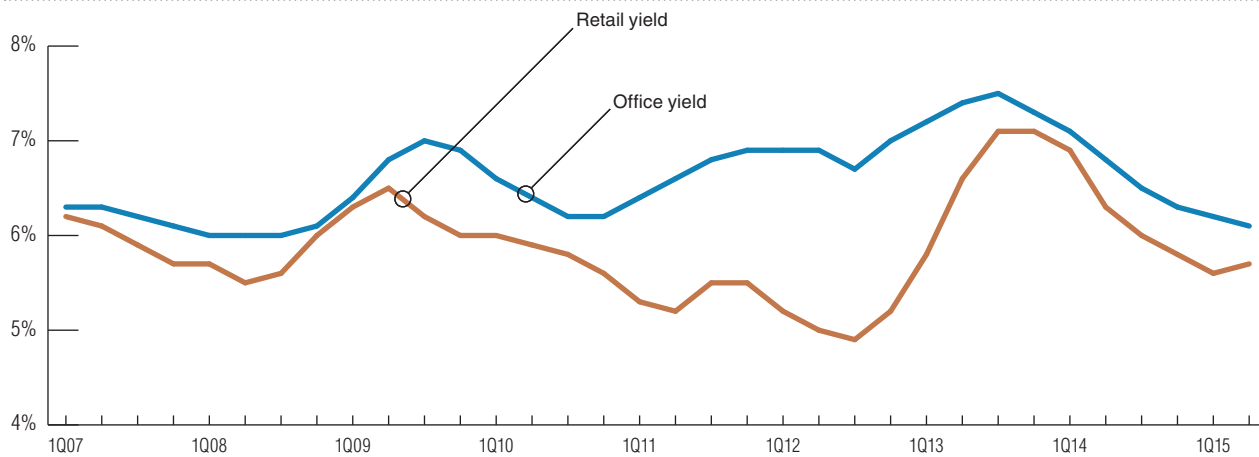
residual decline attributable to a number of other factors. The first, according to one analyst, is a familiar one: "Investors still want to buy, but there just isn't much stock available for trading." Second, buyers in China have stayed on the sidelines as they wait for more clarity over the direction of the economy. Finally, owners have little incentive to sell for anything other than a premium price, making purchases hard to justify on a risk-adjusted basis compared with real estate elsewhere in the world. Many potential buyers have therefore refused to bridge the gap.

Exhibit 1-4 Asia Pacific Transaction Volume by Property Type



Source: Real Capital Analytics, www.rcanalytics.com.

Exhibit 1-5 Yield/Cap Rates in the Asia Pacific Region



Source: Real Capital Analytics, www.rcanalytics.com, October 2015.

Note: Yield/cap rates are four-quarter rolling averages.

The Mexican standoff is unlikely to last, however. With brokers anticipating the closure of several large private equity platform deals in the second half of 2015, the expectation in the market is that volumes will make up lost ground by the end of the year, bringing full-year figures back into line with 2014 levels.

Breaking these figures down among the major markets reveals the following:

- **China** had a slow start in 2015, with soft economic data keeping investors on the sidelines. However, transactions had picked up significantly by midyear, led by a rebound in deals for prime office assets in Shanghai. With a surprisingly strong pipeline of upcoming deals, mainland transaction volumes are expected to accelerate going into the end of the year. In fact, by some estimates, full-year transactions will be 50 percent higher than the 2014 figure.
- **Japan** also has had a strong year, with transactions in each of the first two quarters of 2015 registering among the top three historically. Although the roughly 14 percent devaluation of the yen over the course of last year has reduced returns on a U.S. dollar basis, volumes are expected to remain strong for the remainder of 2015.
- **Australia** has also seen U.S. dollar returns hit by a 21 percent depreciation of the Australian dollar since the third quarter of 2014, but sales activity continues to be some of the strongest on record. Driven by a few large transactions, volumes were up 9 percent in the first half, according to RCA, although the overall number of deals is down on the previous year, reflecting a shortage of assets.

Transactional activity in most other Asian markets was also strong, with the notable exception of Singapore, where a

Exhibit 1-6 Prime Office Yields, Second Quarter 2015

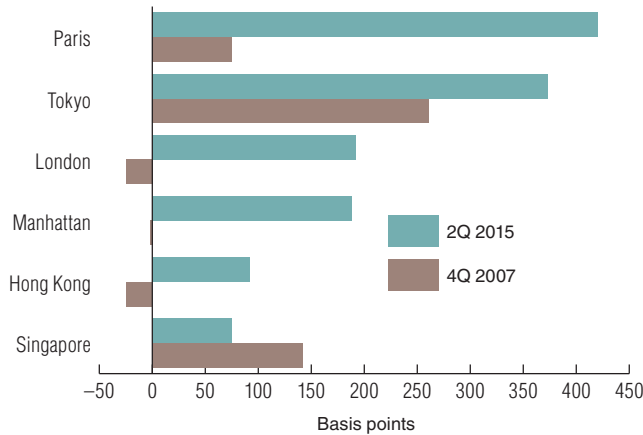
Market	Yield	Year-over-year change (basis points)
Beijing	4.8%	—
Shanghai	4.5%	—
Hong Kong	2.8%	—
Taipei	2.3%	5
Tokyo	3.3%	-25
Seoul	4.4%	-15
Singapore	3.8%	15
New Delhi	8.2%	—
Mumbai	9.8%	80
Sydney	5.4%	-50
Melbourne	6.1%	-25
Brisbane	6.8%	-5
Auckland	6.4%	-35

Source: CBRE Research.

hefty pipeline of Grade A office space over the next couple of years is pressuring rents and occupancy levels going forward. "Volume has been thin over the last six months," said one broker. "Sellers have not been eager to divest, so they're trying to maintain pricing—at the moment we're still trading at the 3 to 4 percent level."

With a relatively weak economy and residential pricing subject to downward pressure, most investors expressed little interest in Singapore—at least for now. According to one fund manager, "The offshore financial services industry there is growing, but at nothing like the pace it was. The wealth management sector is the same. So you've got an absorption problem, but with much less of a domestic scale to support it. I think Singapore looks as though it might become low-

Exhibit 1-7 Spreads: Office Yield versus 10-Year Government Bond, by Country



Source: Real Capital Analytics, www.rcanalytics.com.

hanging fruit, with a more obvious trade over the course of the next 18 months.” That said, some countercyclical investors have already begun nibbling in Singapore’s beaten-up luxury residential market.

Will Yields Continue to Tighten?

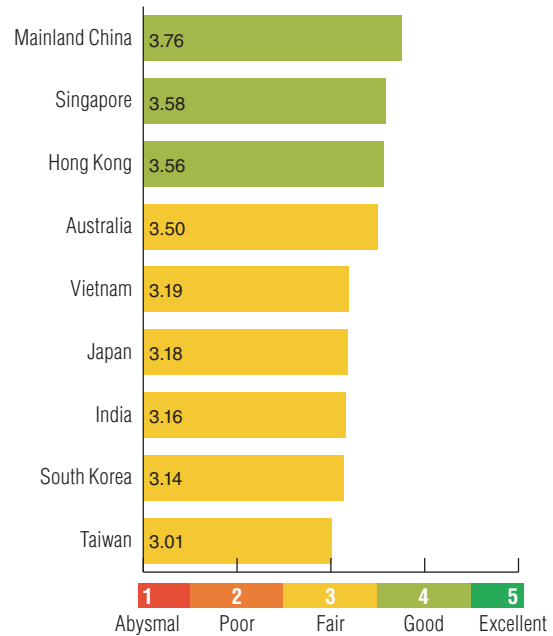
Cap rates in Asia have continued to compress over the last 12 months in most major markets (Australia, Japan, South Korea). They have probably plateaued at very tight levels in a couple of others (Hong Kong, Singapore). And they may have moved out slightly in one (China). The big question now is: Will compression continue? There are two opposing trains of thought.

The first says that we will see more of the same—too much capital chasing too little stock. In particular, new institutional investors will bring more new capital to the market. Existing institutions, which may already be short of interim targets, will increase allocations further. Capital will therefore continue to pile up, with obvious implications for asset prices and yields.

Why is so much new capital targeting Asian real estate? According to one fund manager, “What are the available options? Bonds have no yield, interest rates are at such a low level, equity valuations are not cheap, and fundamentals don’t look good. So where is the best place to put money? People look at real estate and say, ‘Well, if I get a 4 percent to 5 percent pickup in yield, why not?’ ”

There are also other reasons. According to a manager at a large institutional fund, “Most definitely there are a lot more sovereign funds and institutions in the region. Also, in terms of allocation from existing investors working here, there is a desire to put more money out to work. So you have more players and more capital from everybody, which frankly is new to us—it means asset prices are being held up and continue to

Exhibit 1-8 Level of Impact of Global Financial Distress

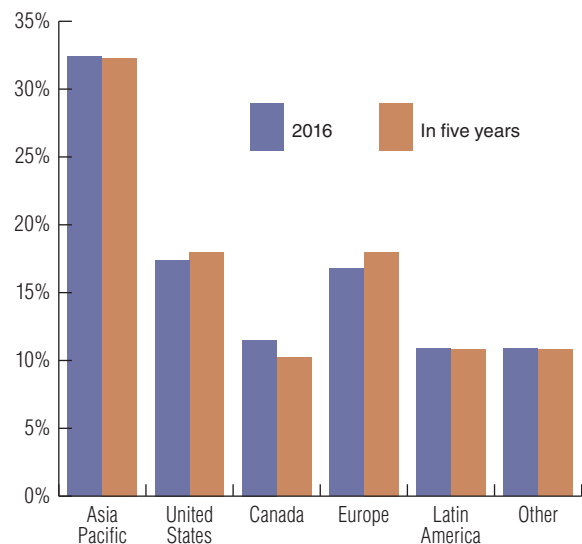


Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

rise. On balance, you will see cap rates staying where they are probably for another year or two, depending on how fast the Fed will increase the rate and how soon.”

Finally, in the words of another investor: “It depends on the market, but if you take Japan and Australia, there’s probably room for more [compression]. If you look at the risk-free cost

Exhibit 1-9 Asia Pacific Investors’ Regional Allocation Percentage



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

of money [i.e., sovereign bonds] in both those markets and then at the yields on real estate, they're still quite attractive. So if you buy an office building in Sydney at 5 percent, you can finance it probably at 2.5 percent to 3 percent, so you're getting a positive carry straightaway. And then you can go a little bit off-piste and buy suburban assets, office buildings, or logistics at 7 percent. I think there's still some way to go because the weight of capital is still massive."

Others Are Less Positive

The other train of thought sees markets approaching a cyclical peak.

According to one investor, "With very low interest rates and significant access to capital, we're seeing very tight cap rates that are not supported by fundamentals. You have economies struggling with unemployment, falling FX [foreign exchange] rates, falling trade, commodity prices, consumption, yet continued low cost of capital and tight cap rates. We see that as a warning sign that the pricing of real estate is out of line with fundamentals and there needs to be some sort of correction. There will be a lot of opportunities coming out of that, but we don't think the markets are in balance at the moment, and that's a bit of a concern."

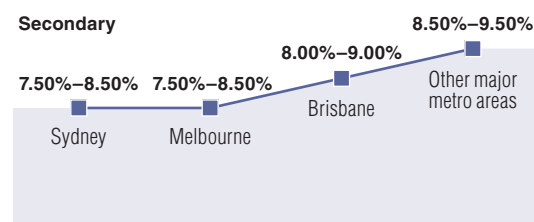
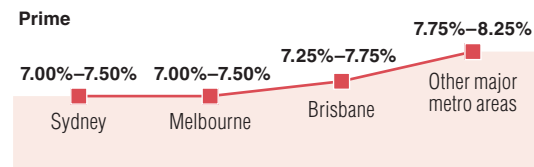
As one analyst commented, "I just don't see cap rates continuing to compress. There are so many unknown issues, in particular interest rates. A U.S. rate increase of 25 bps [basis points] is immaterial, and we still probably have 12 to 18 months of low rates. But I think after the U.S. elections in 2017, there will be a steeper rise. If you look at historical patterns, U.S. interest rate cycles tend to be very aggressive. After that, we have to see some decompression."

Finally: "We've been in a bull market now for six years. Look at the average duration of a cycle; we're already quite late into it—the ninth innings, as they say. So at some point it will turn. What will trigger that is hard to say—nothing right now points to an imminent correction, but I'm sure the market will find a way to surprise."

Sell-Side Activity Increases

Although most investors now in the market are looking more to buy than to sell, an increasing number of funds are looking to divest. To a great extent, this selling is coming from funds disposing of assets bought after the downturn. According to one investor, "The last two years have been pretty good for making money, but that was based on buying stuff four or five years ago, and because so few people jumped in in '09, the [selling] volume still isn't that great. But now you're starting to see people making the good money—it's only just started, and it's going to be a two- or three-year thing." Fund divestments will therefore probably accelerate over the short term.

Exhibit 1-10 Australia Student Accommodation Yield Summary, 2015



Source: JLL Research, 2015.

Note: Referenced against appropriate cash flows; figures apply to single, "best in class" assets.

Another factor behind this phenomenon is that some funds may be looking to sell in order to get ahead of the curve. According to one fund manager, "We've certainly been a net seller in Australia for the last couple of years. Two things—first, cap rates have come down so much. Second, the Australian economy is undergoing a transformation of its own. They've been a big beneficiary of China growth, which has now come off a bit, so we made a decision to lighten up our investment. We're definitely not abandoning Australia, but from a portfolio point of view we decided to reduce our exposure."

Similar sentiment was expressed about Tokyo. As one investor said, "We're still active, we've not said it's overvalued—but at the same time we're selling a ton right now."

Moving Up the Risk Curve

Over the last several years, the standard response among investors to problems in sourcing deals for core assets—high prices, too much competition, a shortage of stock—has been to migrate up the risk curve or to geographically less-crowded markets. That strategy continues today but has declined in popularity given that markets are in something of no-man's-land concerning the possibility of rising interest rates, among other things. In addition, many investors have already explored some of the more exotic alternative investments—student housing, self-storage, senior living—and either exhausted the possibilities in what are generally speaking quite small spaces, or found them wanting in other ways, such as a lack of ready exit options or a requisite level of expertise.

Several interviewees warned that rationalizing investments by looking to adopt more risk at this point in the cycle may be a mistake, with some indicating they were keeping powder dry

Australia: Key Themes

Commercial real estate in Australia has been subject to similar pressures as markets elsewhere in Asia, with intense competition for prime assets pushing cap rates ever lower. Australia's high yields and developed economy, combined with a roughly 21 percent year-on-year decline in the Australian dollar at the end of the third quarter, continue to draw foreign money into both the commercial and residential sectors.

On a transactional basis, Sydney and Melbourne are now the biggest real estate markets in Asia after Tokyo, with some US\$10.2 billion in new capital invested in the first half of 2015 according to RCA, a large proportion of it from foreign buyers, mainly China, Singapore, and Malaysia. With about 30 percent of central business district (CBD) office assets in Sydney now owned by offshore entities, according to broker Knight Frank, the tide of foreign money seems set to continue, if not accelerate.

In the last year, competition for deals has intensified both because more foreign sovereign and institutional players are now looking to buy, and because so few assets are available. As one fund manager commented, "We have domestic, offshore, and pension fund buyers. Everyone is very active for the right opportunity, but there are very few opportunities."

As a result, the market is seeing fewer transactions but bigger ticket sizes, often featuring buyer consortiums. A couple of big deals in 2015—one office, one logistics—

transacted at prices that have retered the core market. Although rumors that some of the buildings involved sold at a yield as low as 4.5 percent are probably incorrect, one locally based fund manager estimated a more likely figure of around 5.25 percent, or about 100 basis points lower than the year-ago level.

Buyers in both transactions, as well as the major bidders, were foreign. That is at least partly because, as the same fund manager noted, "generally, offshore capital tends to have a lower total return requirement than a lot of the domestic unlisted players like ourselves." With foreign funds also able to employ more leverage than domestic competitors, they are often able to outbid local funds.

Can yields continue to compress? The big question is the larger macroeconomic story in Australia, which has weakened with the turn in the global commodities sector on which the economy has traditionally relied. A certain amount of reinvention toward a more service sector-oriented market is now apparent, especially in Sydney and Melbourne. But while local analysts remain cautious about short-term economic prospects, buying by foreign funds implies a more positive outlook. As a result, most interviewees believed that yields still had room to tighten. As one investor said, "Our house view is that Sydney and Melbourne prime offices certainly have a way to run—it's very different in Perth and Brisbane, although Brisbane has held up surprisingly well."

for just that reason. According to a fund manager in Australia, "There are a lot of very strong balance sheets out there and I know we're waiting for a bit of a crash. We can't wait for a market correction because we have plenty of firepower to take advantage of that. The only problem is we're not the only ones." And in the words of a manager at a large Hong Kong-based fund: "I think patience will be rewarded. People might make mistakes quite easily in the next six months. You tend to think that if we sit down in a year's time, there may be more opportunities than there are today."

Of the various alternatives, student housing has proved a popular play in Australia that still offers good yields. The recent decline in the Australian dollar has made the local education system more appealing on an international basis. One Australian-based developer commented that this was now "driving a huge demand in [student] accommodation, especially in metropolitan CBD Brisbane and, to a lesser extent,

Sydney and Melbourne." For investors, this is usually a build-and-hold strategy. Although this trend has yet to spread to other markets in the region, the recent entry of several global investors into what is a fairly finite space has left it somewhat saturated. As a result, "I suspect that game is no longer as attractive," according to one institutional investor.

Senior housing and health care also cropped up several times in interviewing as an interesting option regionally, and there is certainly demand for the product. "You look at the demographics in China and it's horrifying," as one investor put it. But problems in structuring this type of deal remain. In particular, there is a fundamental issue over affordability of care for Asia's elderly demographic, and despite the growing availability of government incentives, the added layer of bureaucracy that creates is itself a disincentive. According to one fund manager, "We still are interested in senior housing and health care, but the problem is that you tend to have to deal with

This is especially so given the volume of new capital that continues to arrive and the fact that most of it is longer-term money less fixated on fast returns. According to one interviewee, “People don’t come here to get that opportunistic exposure. It’s not highly leveraged. Returns in the core space are driven by the underlying real estate and not debt. Besides, where else are you going to get the level of income return and total return, even if we’re closer to the top than the bottom of the market?”

With yields for core having compressed much more than those for other asset types, more attention is now directed to value-add plays, metro areas, or cities other than Sydney and Melbourne. According to one investor, “There’s definitely been some significant cap-rate compression in the noncore space, but it’s nowhere near the level it was at the peak of the last cycle.” Local institutions are generally sticking with core due to their negative experiences in secondary assets during the last cycle. However, some investors, including local unlisted funds and a few foreign buyers, are becoming active in noncore markets, especially on the residential side. There also has been a large recent increase in transactions of neighborhood and subregional shopping centers, partly because they are seen as defensive plays, and partly because retail yields have not compressed to the same extent as those in other asset classes.

In the residential sector, prices have continued to balloon upward, rising 24 percent nationally (and 46 percent

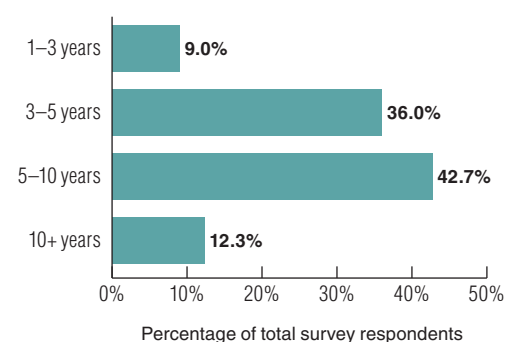
in Sydney) in the three years to September 2015. A note published by investment bank Goldman Sachs in September 2015 stated that home prices nationwide were 20 percent overvalued. Together with a strong supply pipeline, this has led to a revival of the longstanding housing-bubble thesis, especially in the big cities where price increases have been highest. Anticipated increases in unemployment (now exceeding 6 percent nationally) have underpinned this argument, as have slowing population growth and rising mortgage rates. At the same time, however, residential prices are likely to be supported by relatively low loan-to-value (LTV) ratios, as well as mortgage interest rates that have dropped to a five-decade low following ten interest rate cuts since November 2011. With no rate increases expected in the near or medium term, this should help keep mortgage repayments at an affordable level.

Meanwhile, the office-to-residential conversion story in inner-city Sydney and Melbourne remains strong, although recent indications from local governments in both cities suggest that the planning environment is about to become problematic. As one Sydney-based interviewee commented, “The city council doesn’t want to see commercial space necessarily converted to residential because they take the view that you have to have a vibrant commercial area to be an international city, and once it’s converted to residential you never get it back.” It is therefore probably fair to say that this trend is slowing.

governments and regulatory aspects when you talk about senior citizens, and that makes it difficult to underwrite a deal.” A possible exit strategy for investors into China’s nascent real estate investment trust (REIT) sector was mentioned as a potential driver for the market.

Though it can no longer be regarded as a niche area, logistics infrastructure also remains very much on the radar, especially in China, where more the US\$9.5 billion in capital has been deployed in the past two years, according to brokers Jones Lang LaSalle. Returns are still relatively strong, although concerns are building over upcoming oversupply issues. According to one investor active in the sector, “Development yields are, say, 8-plus percent, and cap rates are probably 6-plus percent, so you’ve got a nice 25 percent plus or minus development margin. If you look at it on a per-capita basis—the stock of logistics facilities in China versus the U.S. or elsewhere—it still has a ton of room to run. There’s been a lot of capital going in, though, especially from offshore. The

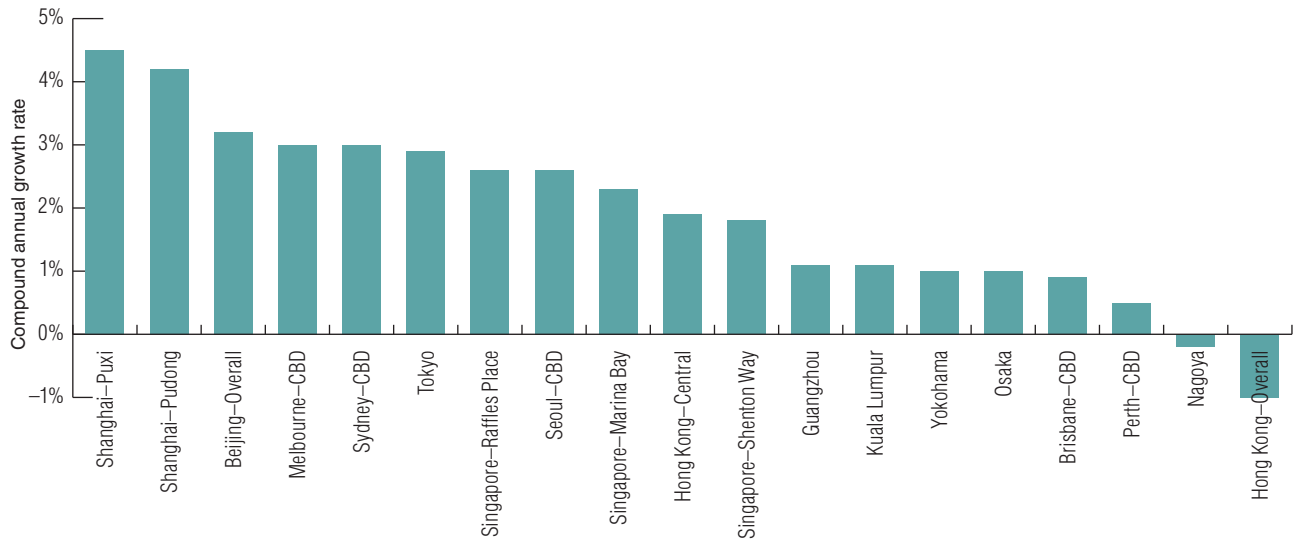
Exhibit 1-11 Time Horizon for Investing



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

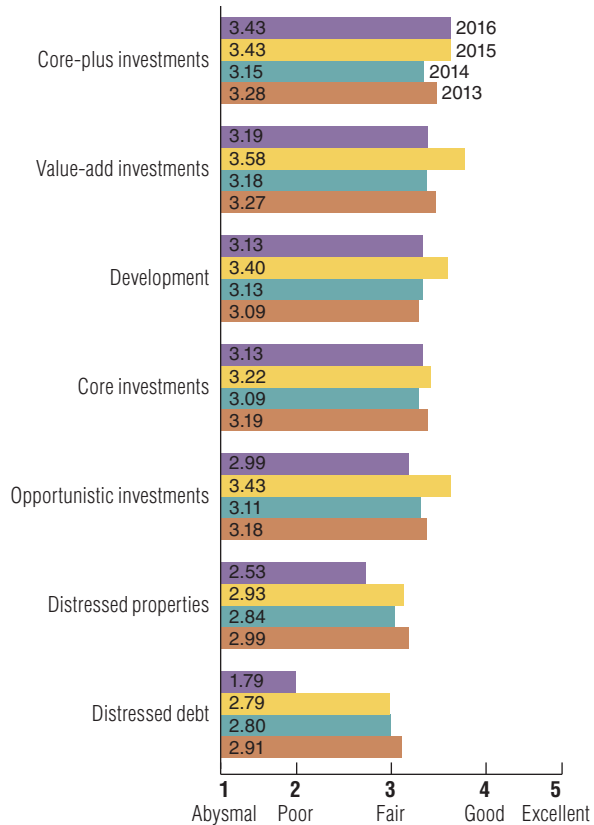
question is the timing—when will it all come online? If you’re a short-term investor looking to just develop and flip, maybe you don’t want to be taking that risk, because if your project comes online and there’s a competing one close by, you’re

Exhibit 1-12 Annual Office Rental Growth: Forecast 2015 to 2019



Source: Deutsche Asset & Wealth Management.

Exhibit 1-13 Prospects by Investment Category/Strategy for 2016



Source: *Emerging Trends in Real Estate Asia Pacific* surveys.

going to be competing on rents, and that could come back to haunt you.”

Rental Growth or Yield Compression?

With yields already tight, expecting much more by way of cap-rate compression seems a big ask, which is why many investors are now looking for rental growth to shore up cap rates by keeping up with future capital value increases. According to one interviewee, “Everyone is looking for rental growth next, which would restore yields back to a more normal position over a longer period. So if you’re buying something now, I don’t see capital values falling particularly; I think there’s likely to be much more stability there—it will be rent growth that investors are looking for.” This thesis applies particularly to Japan, which has suffered from low or no rental increases for many years.

Whether the rent-growth theory is simply a rationalization created by wishful thinking remains to be seen, but projections for rents across major markets do not currently suggest that big increases are in store, with the possible exception of China, where rents in tier-1 cities have a track record of defying both supply gluts and analyst expectations.

This may be why investors’ expectations in regard to returns as reflected in our survey (see exhibit 1-13) are lower this year in almost all asset classes with the exception of core-plus.

According to a Tokyo-based investor, “People are expecting rents to rise. The problem is that while we are seeing some growth—mostly in office and residential—it’s really moderate. And a lot of people here are now questioning the ability

Exhibit 1-14 Top 30 Global Markets

Rank	Market	Mid-2015 sales volume (US\$ million)	Year-over-year change
1	New York City metro area	36,849	59%
2	London metro area	29,730	48%
3	Los Angeles metro area	16,878	25%
4	San Francisco metro area	15,941	30%
5	Tokyo	15,752	-21%
6	Chicago	9,671	94%
7	D.C. metro area	9,182	37%
8	Paris	8,315	-34%
9	South Florida	7,120	88%
10	Dallas	7,014	28%
11	Atlanta	6,818	76%
12	Boston	6,533	33%
13	Seattle	6,254	89%
14	Houston	5,567	37%
15	Berlin-Brandenburg	5,267	106%
16	Melbourne	5,191	15%
17	Sydney	5,012	-20%
18	Amsterdam/Randstad	4,856	40%
19	Phoenix	4,345	86%
20	Frankfurt/Rhine-Main	4,325	44%
21	San Diego	4,318	37%
22	Hong Kong	4,138	-26%
23	Denver	4,042	26%
24	Orlando	3,791	280%
25	Austin	3,778	61%
26	Hawaii	3,716	28%
27	Madrid	3,580	156%
28	Rhine-Ruhr	3,249	-18%
29	Munich	3,011	18%
30	Shanghai	2,756	-33%

Source: Real Capital Analytics, www.rcanalytics.com, October 2015.

Note: Property types included are office, industrial, retail, apartment, and hotel. Based on properties and portfolios valued at US\$10 million or more.

of Abenomics to get inflation going, which would obviously lead to rents rising. So the question is: Without wage growth and without any inflation, is it sustainable? I don't think it is." Although Tokyo rents are currently much lower than they were when the last cycle peaked in 2007, a significant pipeline of new supply starting next year means the window of opportunity for rental growth in Tokyo may be closing.

Australia, too, may struggle to deliver the volume of rental growth required to keep up with the recent rate of cap-rate compression. While vacancies have fallen steadily in Sydney, they remain elevated in Melbourne, and significant levels of upcoming supply may keep big rent rises in check, especially with incentives at historically high levels.

Indeed, more than a few interviewees were skeptical that regional markets that have historically been driven by expectations of capital value growth can switch so easily to a rent-driven model. According to one consultant active across the region, "For nearly all the people we're involved with, it's capital gain. Obviously, part of it is a function of rental growth reflecting growing incomes and increased demand. But mostly in our conversations, the focus is invariably around capital growth."

One interviewee deemed this issue potentially problematic for the region going forward: "I think rental growth will be relatively slow, and that goes to my thesis for the APAC [region]. If I were a global fund manager, I'd probably go the other way, to the U.S.A., right now, and underweight APAC in a big way.

Japan: Key Themes

As with other markets around the region (with the exception of China), the Japanese market has more buyers than it has available assets, meaning that “it’s still difficult to get stuff tied up because there’s so much competition.” An influx of new foreign institutional investors, mainly Asian but also including a number of Middle Eastern and European sovereign funds, has arrived this year, picking up the slack in the core market from local real estate investment trusts (REITs), which have now eased back on their buying.

Prices and cap rates have tightened considerably over the last year, with office values in Tokyo up 20.6 percent year-on-year in the first half of 2015, according to Jones Lang LaSalle, and cap rates compressing to as low as 3.3 percent as rents increase slowly but struggle to gain traction.

The retail and hotel sectors are the current bright spots in Japan, driven largely by surging tourism that has, in turn, been generated by a nearly 35 percent depreciation in the yen over the last three years. Chinese visitor arrivals have been especially strong, as mainland tourists migrate further afield from traditionally popular destinations such as Hong Kong. Prime retail rents have spiked to levels unseen since 2008 and buyers have been “very, very active,” driving down cap rates even further. Hotels have had an equally strong year for the same reason. They are seeing increased

demand but lack sufficient capacity, which has driven room rates sky high, especially at the top end.

Residential markets are somewhat more stable, with little new construction meaning a positive supply/demand balance. Cap rates are in the area of 4 percent, and there is moderate rental growth of 2 to 3 percent, with higher increases constrained by lack of wage growth.

Meanwhile, B-grade office—once a safe harbor for value-add foreign funds excluded from the core market by big-spending local REITs—is no longer a favorable play. According to one local fund manager, “A lot of tenants in B-grade buildings have moved into A-grade buildings because landlords are now willing to divide up these large floor plates into multiple tenants, whereas before they wouldn’t do that.”

The question is: what happens next? Anecdotally, investors are now bidding under 3 percent for A-grade offices, but that may represent a threshold. According to one investor, “I don’t say it’s reached the top, but I think it’s starting to plateau a bit, so people are deciding if selling now is a good time.”

Although investor profits have been very strong in Japan over the last couple of years, and promise to remain so into 2017, most interviewees were skeptical about

Traditionally, APAC markets trade at very low yields, but that doesn’t matter because I can rely on stronger rental growth to offset those higher prices. But now, your [cap rates] are at a historical low, so if rental growth doesn’t happen, what are you going to do?”

The answer may be that cap rates continue to trend downward no matter what. In the words of one regionally focused fund manager: “Generally, there probably is more [compression] to come, but I’m less focused on that as an issue. I try to look at it as a total picture of net operating income [NOI] and capital values. I just think capital values are going to continue going up in Asia, and the driver is the same as a couple of years ago—the weight of capital in that core space.”

Investors Stick with Core

The growing preference among investors for core assets has been a consistent theme in Asian real estate for the last several years. That continued in 2015, with predictable consequences. As one investor said, “The challenge on the core side is that there are more people interested, but there’s

not a lot of stock.” This competition for deals among so many well-capitalized players is one of the major factors adding to ongoing cap-rate compression.

One reason behind increasing demand for core is Asia’s changing mix of investors. With real estate in the West offering arguably better risk-adjusted returns, the flow of private equity to the region is probably not as strong as it might be. Institutional and sovereign capital, however, continues to pour in from a variety of sources, creating disproportionately high demand for core buildings.

Another reason is that demand for defensive assets is increasing in a global macroenvironment where the perception of risk escalates each year that U.S. base rates remain near zero. This has seen investors crowding into gateway cities because, as one fund manager put it, “as soon as you start going off-piste into exotic sectors or peripheral markets, you’re asking for trouble. From an evidence perspective, if you look back at all of our deals, even if you have to overpay for an asset in the middle of Shanghai, it’s better than trying to be clever and get something cheap in Nantong.”

prospects over the longer term. Problems relate to the economy (confidence in Abenomics is low), a prospective consumption tax hike due in 2017, and, in particular, concerns about current investment trends driven by ready access to cheap bank debt. With the cost of capital falling this year to below 1 percent all-in from levels of around 1.4 percent a year ago, there has been a rush of investments based on cheap short-term debt levered as high as 90 percent. It is a strategy that has paid off handsomely for those who bought a year or more ago, but such financially engineered plays are very vulnerable to changes in market momentum.

With current bets predicated on a pickup in rental growth, “if that doesn’t happen and these higher-LTV loans come due, I think you’re going to start see refinancing risk hitting the market starting about 2018,” said one locally based investor. “That’s because the fundamentals are not there—cap-rate compression is purely and simply to do with [the availability] of the cheap debt. If you take that away and go back to 65 percent-type financing, you’re not going to be able to pay those numbers, particularly if you do have a really moderate rent growth. It just wouldn’t make sense on a risk-adjusted basis.”

Given this risk, an alternative play at the moment is to borrow low-cost fixed-rate money for ten years at more

conventional leverage of 60 percent, together with assignability provisions. On the one hand, “that allows you to make investments where you’re clipping a very healthy double-digit cash-on-cash yield that provides some good downside protection, even if values were to come down a little bit.” On the other, “if within ten years you want to sell and interest rates do go up, you’ll get value just with the loan attached to it.”

While Tokyo remains the focus for most investors in Japan, regional cities continue to draw investors. The yield spread between secondary cities and Tokyo has narrowed this year (in Osaka, Nagoya, and Fukuoka, for example, it is about 200 basis points) but still provides significant upside, together with easier access to deals compared with the highly competitive environment in the capital.

Finally, another interesting theme that has recently emerged from Japan is its potential as a fundraising destination. With many of the local pension funds, and in particular the huge government-backed Government Pension Investment Fund (GPIF), due to increase allocations into alternatives, including real estate, many global private equity players are now anticipating being on the receiving end of some of the US\$12 billion to US\$18 billion in new capital expected to be allocated.

On that basis, an absolute focus on pricing and yield becomes less important. According to one interviewee, “Even people trying to generate double-digit returns are looking for the option value, where their baseline doesn’t feel so bad. Maybe [the deal] will only break even, but if the timing is correct and the asset management strategy outperforms, or something of that nature happens, you get to your returns.”

Unfashionable Markets More Popular

This may be why some markets previously deemed too tightly priced or otherwise unattractive to foreign investors are once more gaining traction. Shanghai is one example. With net yields for core assets hovering at an “eye-poppingly low” 4 percent to 5 percent, the city was previously passed over by many foreign fund managers who saw little value on a risk-adjusted basis, except possibly on a build-to-core basis. In 2015, however, at least eight large deals involving foreign capital are expected to close by the end of the year, according to an interviewee based in Shanghai.

The reason? As one fund manager observed, “In tier 1, if you buy a good asset, you’re not likely to lose money at this entry point, assuming [the price] is reasonable.” In addition, tier 1 offers a reasonable chance of extra upside. “The one thing you don’t know in China is whether the continued trend of institutionalization of the real estate onshore will help you. So as deposit rates trend down, people onshore might think that a decent income asset in Shanghai or Beijing looks good relative to the deposit rate.” To succeed, the extra-upside scenario would require a change in mentality among a local investor base that historically has not valued recurring income in the same way as in the West. In China, “they’re looking for the quick capital value pop,” the manager continued, “but if that mentality switches in the next one to three years, that could create enough of a wrinkle for the medium- to high-risk strategies to buy and flip.”

Hong Kong is another richly priced core market where investors are now taking another look. Sovereign funds, for example, have figured in two large deals there in 2015. Despite offering the lowest cap rates in Asia (core properties

trade in the area of 2.7 percent), the city cropped up several times in interviews as a potentially interesting investment. Office in the central business district (CBD) of Hong Kong Island tend to be closely held and rarely trade, but ongoing redevelopment of parts of Kowloon as a “CBD2” presents more interesting opportunities. According to one investor, “Prices are a little high, but if you think you’re getting a bit of a dip and things are going to go back to more normalized levels, it might be worth a shot. Again, it offers good-quality real estate and a good cash profile in a major developed city that hasn’t come off in value dramatically. I think it’s a function of that relative value trap—if you’re sitting on a pile of cash, what else are you going to invest in? So when a decent asset even in Hong Kong comes up, and it’s income-oriented, it’s still getting bid strongly.”

Finally, South Korea also is drawing increasing interest from core (and for that matter, noncore) investors who for years saw little to attract them. The issue in the past was not so much overpricing as it was getting a foothold in the market. Now, access is not seen as such a problem: “The reason to look there is that you’re going to look at any place where you have some margins on the asset. And anyway, there isn’t as much offshore capital looking for deals.”

The fact that Seoul is a gateway city is a key attraction, as is the fact that “if you look at the office price per foot, it’s the cheapest office space in Asia for any key city.” Demand/supply dynamics for office assets are considered good, and cap rates have compressed but are still in the region of 4.5 percent, while the low cost of capital means that investors have a positive spread over the cost of debt.

Opportunistic Remains Tough

While their ranks may have thinned over the past eight years, opportunistic investors remain active despite a general shortage of qualifying assets. According to one manager, “It’s a bit challenging in the opportunistic space. There’s a risk-off approach to real estate investing, so we haven’t seen a lot of opportunistic capital raised in Asia recently, [but] where it is focused is on development and on leveraged plays into Japan.”

What qualifies as an opportunistic return continues to contract as yields shrink. According to one investor, “Our view is that you can get good risk-adjusted opportunistic returns if you’re happy on a gross basis at around 20 percent. That’s very achievable with sane underwriting and with partners who feel comfortable going to bed at night. Getting from 20 percent to 25 percent—it seems like a small number, but I think it’s a chasm, because you’re going to have to question the risk you’re taking on. Most of the sovereigns, the big pension funds, the guys who are going direct are actually comfortable

with even lower returns than that. Even in development risk, I think for opportunistic they’d be happy if they get 16 percent, 17 percent, 18 percent.”

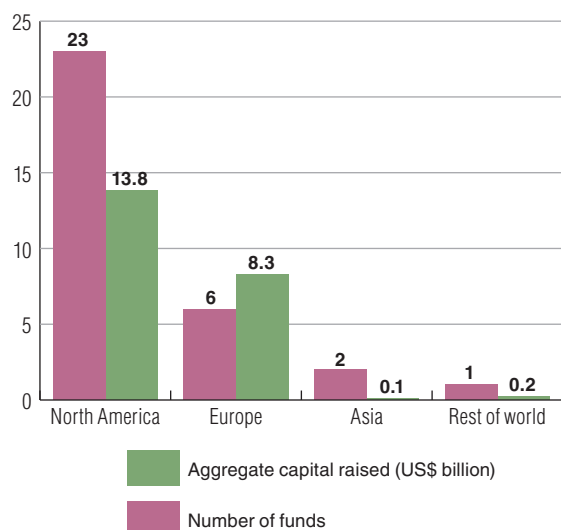
Because opportunistic investing is generally not thematic, identifying specific types of deals is difficult, especially given the overall shortage of suitable assets. As one opportunistic fund manager said, “At this point in the cycle, I think all you’re trying to do is stay one step ahead of that core capital. So as that definition continues to expand, which is natural at this point in the cycle, you want to pick assets or geographies that could be that next step. Then you’d have some active asset management to hedge it, and with your positive debt cost you should be able to get to mid-teens [returns].”

Japan and China Offer Opportunistic Returns

Notwithstanding the nonthematic approach, Japan continues to be a favorite target for opportunistic funds, although some of the deal-structuring strategies used are beginning to raise eyebrows. Cap rates in Tokyo may be hovering at a miserly 3.3 percent, but ultra-low borrowing costs create cash yields that can be levered as high as 90 percent—by far the highest loan-to-value (LTV) ratio in the region. As a result, more and more investors are willing to take short-term levered debt and buy at very compressed yields on the basis that further yield compression will provide outsized returns. So far, they have been right, but many experienced investors are wary of a repeat of 2008, when others playing the same game were badly burned after the markets crashed. As one investor said, “It works good when it works. The problem is, when it turns, it’s really ugly.”

China is another market with opportunistic possibilities. Ongoing economic issues, chronic oversupply, and declining development margins mean that investors have to be discriminating. But they also mean potentially higher profits. According to one investor, “We still think there’s a lot of opportunity because of fundamental demand, but it’s very locational-driven, it’s really micromarket. In some ways, having a stressed situation with that strategy is quite a nice place to be—provided you have an investor base comfortable with being contrary.”

With Beijing and Shanghai remaining highly competitive, suitable deals are more likely to be found in secondary locations. That may mean, for example, helping develop a flagship project in a prime location, with good transportation links and a reliable partner from the same city. In the past, foreign investors would probably never have had access to this kind of project. According to one opportunistic investor, “The key thing for us is alignment of interests. Today that alignment is eco-

Exhibit 1-15 Closed-End Distressed Private Real Estate Fundraising, by Primary Geographic Focus, 2013–2015*

Source: Prequin Real Estate Online.

*As of August 19, 2015.

nomie. The good thing for us is that developers need capital so they can fill a funding gap and adapt their business models. But for us, it's about protecting ourselves, so we like to be in the projects that really matter to these guys, whether that's near-term generation of cash flow, or whether it's scale—stuff that they just have to focus on. Because there are always going to be cycles, and when Rome is burning, my view is you better be invested in Rome, because that's where all the resources are going to go."

In particular, mid-range residential plays continue to appeal, even in tier-1 locations where impending policy changes

promise to open up markets to formerly excluded classes of out-of-town buyers. According to one active investor, "Demand/supply dynamics remain quite compelling in many cities, and the overall pricing environment in terms of developers' access to capital is better today than it has been. There's less cheap debt and equity available onshore, which makes our kind of capital more competitive—in that environment, you're able to do better deals with better partners."

Distress Remains Elusive

Meanwhile, the outlook for distress in Asia has become ever more tenuous. For years, investors looking to pick up distressed assets in the fallout of the global financial crisis came away empty handed. This was largely because Asia's relationship-driven markets tend to deal with defaults via connected parties or as part of some compromise with the lender rather than by way of sales in the open market. Distress has therefore disappeared from the radar for most fund managers.

With the possible exception of India, the only realistic prospect for distress in Asia today is in China, as small and medium-sized developers continue to scramble for construction finance, especially in second- and third-tier cities. Even then, however, this scenario is more theoretical than real. While there is no shortage of local developers willing to sell out or accept rescue capital, interviewees saw little chance of many deals panning out for foreign firms. One reason for this is that Chinese authorities may be unwilling to allow distress opportunities to be intermediated by the market. As one interviewee said, "I think the government will do something to contain it, which will make it difficult for offshore investors to truly get access. They'll probably go back to the asset management companies and it'll be a repeat of 2002, when everyone

Exhibit 1-16 Real Estate Transparency Scores: Asia Pacific

Transparency level	Country/region	2014 rank	2014 score	2012 score	2010 score	2008 score
High transparency	Australia	3	1.4	1.36	1.22	1.15
	New Zealand	4	1.4	1.48	1.25	1.25
Transparent	Hong Kong	14	1.9	1.76	1.76	1.46
	Singapore	13	1.8	1.85	1.73	1.46
	Malaysia	27	2.3	2.32	2.30	2.21
	Japan	26	2.2	2.39	2.30	2.40
Semitransparent	Taiwan	29	2.6	2.60	2.71	3.12
	China (tier-1 cities)	35	2.7	2.83	3.14	3.34
	Philippines	38	2.8	2.86	3.15	3.32
	Indonesia	39	2.8	2.92	3.46	3.59
	Thailand	36	2.8	2.94	3.02	3.21
	South Korea	43	2.9	2.96	3.11	3.16
	China (tier-2 cities)	47	3	3.04	3.38	3.68
India (tier-1 cities)	40	2.9	3.07	3.11	3.44	
Low transparency	Vietnam	68	3.6	3.76	4.25	4.36

Source: Jones Lang Lasalle, *Real Estate Transparency Asia Pacific*.

China: Key Themes

For a number of reasons, property market sentiment in China has been negative for most of 2015. A combination of a softening economy, a devaluation of the yuan, and the crash of the Shanghai stock market in the middle of the year resulted in a sharp slowdown in most sectors. The residential market saw pricing and transactions fall across the country (apart from tier-1 cities) during the first half of 2015, and followed equally weak data from 2014. On the commercial side, transactions have also fallen (by some 26 percent year-on-year, according to RCA), although asset prices generally remain strong.

Investor views on China have become quite polarized as a result. Some see the current problems as a bonus. For others, in particular Western-based investment committees viewing China from afar, it has created a crisis of confidence. As one investor put it, “Everybody is in wait-and-see mode because at the moment it’s very difficult to convince people in New York that China is a good place to park retirement savings.”

In the end, these two viewpoints may cancel each other out. According to a Hong Kong-based broker, “It hasn’t affected the development side because that takes time, but it has a bigger impact on the investment community, so people who would have done deals have postponed them. Then again, there will always be a new group of people who see opportunity, so I don’t think there will

be a big fall-off in transactions—you’ll just end up with a group of opportunistic people.”

Sentiment improved somewhat in the second half of the year following the introduction of a number of policy initiatives aimed at boosting capital flows into real estate. Six interest rate cuts since November 2014 have now lowered developers’ cost of capital, while access to finance was improved in both onshore bond markets and at the household (i.e., consumer mortgage) level. As a result, by the end of the third quarter, home sales had increased 30 percent year-on-year in China’s ten biggest cities, according to one report. Pricing in tier-1 cities, meanwhile, has continued to rise moderately.

On the investment side, sentiment has been on a roller coaster. Interest among foreign funds fell off in the first half due to China’s much-publicized economic problems, but thereafter picked up sharply as investors realized the sky wasn’t falling. According to one foreign banker active in China, “What happened is that early this year, it looked like it was going to be a great year. Then, the summer problems caused deals to be delayed. But now I see all those deals are going to get done, so by the end of this year there are a huge number of trades in the pipeline, something we haven’t seen in a long time.”

Why? Foreign investors are certainly wary of investing in China in the current environment, but with more and better

thought there would be a ton of broad-based distress, and there was, but it just got swept under the carpet.”

Another reason is that most foreign funds see such partnerships as too risky. Entity-level deals are unappealing because small and mid-sized developers often have opaque finances and are likely to face ongoing discrimination in sourcing finance going forward. At the same time, project-level deals are usually unattractive, partly because they are usually located in secondary cities where a supply glut already exists, and partly because the time needed to negotiate, execute, and turn around individual assets often makes them uneconomic.

Finally, structuring distressed deals is also problematic because even with a bulletproof contract, trying to enforce it against a prominent local company is challenging. As one fund manager put it, “You think just because you’ve got your distress deal with some third-tier developer that you’re going to go into his town and kick him out? It’s just delusional. We

still hear a lot of people talking about how they’re going to play the distress. I don’t see it. I think we’re going to see distress, but the best way to play it is to back these big [local developers] buying into it—then again, even the big guys don’t like it.”

Platform Deals Increase

A new phenomenon recently appearing both in China and across the region is the growing number of platform and entity-level transactions. These may involve, for example, the acquisition of portfolios of assets in Australia or purchases of equity stakes in large developers in China. For buyers, this type of deal offers the advantage of scale—an important consideration for both global private equity funds and big institutional players who need to deploy ever-growing volumes of cash into markets with relatively few suitable assets. A number of entity-level deals were also struck in India in 2015.

In China, this type of deal does not generally involve distress. Most larger domestic property companies remain well capital-

deals now available, the fear factor has diminished, especially among investors who are already on the ground. As one Hong Kong-based fund manager put it, “I think China is the one market in Asia right now where there’s a need for capital. In a lot of the other markets—Japan, Australia, Hong Kong, Singapore—there’s more capital than product or opportunity. Investing in China involves more risk, but there is that need for capital and because there isn’t as much competition, there are some good opportunities to be had.”

What are the risks? With a few notable exceptions (such as Nanjing, Xiamen, and Wuhan), overbuilding in secondary locations has created a glut of often-misconceived projects that will take years for the market to absorb. As one investor said, “Before, you could think: ‘Right partner, good second-tier city, growth will likely bail us out if we get the project selection wrong.’ Now, that’s less and less true—you’ve got to be a great deal more selective about the markets in which you choose to invest.”

In addition, the government’s ongoing anticorruption initiative has been a drag on decision making, especially for development projects. According to one Hong Kong-based consultant, “The campaign has slowed down everything because no one’s willing to make major decisions in case they’re accused of having an interest in making it. Across all our schemes, we’ve lost an average of about 12 to 18 months.”

Institutional and core funds, therefore, are now back buying prime income-producing assets in tier-1 cities (especially Shanghai). Investors with higher hurdle rates are again looking at development deals in secondary locations, often in the mid-range residential sector and despite persistently high inventories. As one investor said, “I like residential even though equity multiples are relatively low. You’re doing a lot of work and maybe getting a good IRR, 20 percent or high teens, but your equity multiple is going to be 1.5 times, which is a lot of work for not a huge multiple and a fair amount of risk. So I think it’s not for everyone, but in terms of where the best opportunities are right now, that’s probably it.”

The retail sector, meanwhile, remains volatile, despite a few big deals recently struck by foreign capital. “You have to be extremely careful,” said one investor. “If you can find suburban locations that are undersupplied for everyday shopping, or if you have a good residential proposition and as part of that you can build something manageable in the retail context, then you have a chance. But in city centers and in primary and secondary markets, for the time being there’s just way too much competition. Could there be opportunities to recapitalize deals or buy distress at some point? That might happen, but we’re not seeing it yet.”

ized and will probably continue to receive preferential access to bank borrowing. Unlike in previous years, though, Chinese developers are now interested in partnering with foreign money because the rapidly changing industry landscape is forcing them to adapt their operating models. As development margins in China thin from net levels of 20 percent to 30 percent ten years ago to an average of 0 percent to 10 percent today, the big builders are increasingly looking to be less capital-intensive, more efficient, more diversified, and more fee-driven. In addition, they want to operate on a global basis—something they are quite capable of doing given the sheer scale of their businesses and their experience in mass-market construction.

Collaborations with well-known international investors or developers can help achieve that. In addition, partnering with a well-known name brings a level of credibility when operating in foreign markets where the Chinese brand is unlikely to be well known.

For the foreigners, the operational benefits of entity-level partnerships in a market as complex as China are obvious. For one, they provide access to a volume and quality of deals they could never otherwise tap. In addition, they provide a measure of safety. According to one interviewee, “Buying into the corporate entity gives a greater feeling of security because you’re getting a much better spread across their whole range of projects.”

Emerging Markets Tough to Access

Interest among foreign investors in the potentially high returns offered by Asian emerging markets has been strong for several years, and has probably increased recently. According to one broker, “You’d be surprised. They’re small, but in Asia there are not many other markets to go to. We’re doing a lot right now in Myanmar, Cambodia, Bangladesh—the sort of places that are not normally on the radar. This may reflect that people are having to move further out in order to get their returns, whereas in the more mature markets they can’t get

projects, or they don't like what they're being offered." That said, however, emerging and frontier markets remain very difficult places in which to invest.

There are various reasons for this. One is that these markets tend to be dominated by a small number of homegrown players with easy access to cheap capital and little need for the more expensive money offered by foreigners. As one investor said, "We want to be working with the more established guys, but they just don't need our money, they're not going to pay [what we want] for it, they're not going to give the control rates we want." Another reason is that the generally small deal sizes on offer in emerging markets "don't move the meter" for funds needing to deploy large amounts of capital. In addition, and particularly for institutional investors, there may be sensitivities related to potential problems with corruption or some other type of political scandal.

Finally, the locals have a different perception of risk. One investor active in Vietnam recounted how his fund's ongoing divestment program had managed to attract only local purchasers. "Foreign funds have come in and looked, but they see country or political risk as a factor that needs to be quantified and built into the equation. Locally, though, country risk is not on the agenda—they just believe that one way or another they can get it done. So risk profiles are very different and that affects the bidding—we're seeing bids from locals 20 percent to 30 percent above what an overseas buyer would pay."

In the Philippines, the situation is similar. According to a Manila-based developer, "In most cases, [buying] interest is local. Investors coming cross-border have to factor in the exchange rate, so they may have to hedge, and that can cost another 4 percent to 5 percent. Then there's political risk, so very often you're hitting something like 20 to 25 percent, which is a very high hurdle, since money here can be had at 3 percent to 7 percent and banks are anxious to lend."

These various barriers to entry mean that most deals involving foreign capital tend to involve certain types of buyers. These include in particular large diversified developers from Singapore and Hong Kong that are familiar with local operating conditions. More recently, they also include Middle Eastern and Asian sovereign wealth funds. Either way, investors are likely to have a long-term perspective (i.e., ten-plus years) rather than a conventional internal rate of return (IRR)-driven mentality.

Another type of emerging-market investor is the smaller, fast-moving, adaptable buyer willing to make early-stage development commitments in markets like Myanmar (labeled "the darling of 2015" by one interviewee). According to a representative of one such investor, "It's all about land conversion—buying farmland, converting it into building land, getting

all the permits, getting investment licenses, clearing it, putting infrastructure in, then selling on to the local development community." This type of play is relationship driven and therefore not a game for institutional players. It is predictably high risk, but can also be highly profitable. In many markets, "you make literally 80 percent to 90 percent of your development profit getting it ready to go; in fact, in all the cases we've looked at, you make less money by being a developer."

Emerging Markets Correction?

Development activity over the last two or three years has been strong across most, if not all, of Asia's emerging jurisdictions. However, while the Philippines and Vietnam continue to promise upside, sentiment among interviewees toward Southeast Asia suggested "a definite sentiment of malaise just about everywhere." Indeed, in most markets there is clear evidence of supply gluts, especially in the office and high-end residential sectors.

Combined with the potential for economic volatility described above, this has led to speculation that there may soon be scope for distressed opportunities on the downside, particularly in Indonesia. According to one institutional investor with experience in Southeast Asia, "We have a lot of interest in pursuing development there, but there is a time to invest and a time to wait. We think some of these countries may be heading for a correction and we're just getting ourselves ready. Selectively, we might do one or two things there, but I don't think it's time yet to systematically go into these markets."

Another Jakarta-based investor commented that in the residential sector, "developers are now moving from the high-middle to the lower-middle range, where there's better affordability. The higher end will slow down significantly—properties are expensive and people are tightening their belts. In addition, some of the developers with U.S. dollar debt who don't have access to foreign currency revenue may just put their projects on hold—we think it could create a good opportunity [for distress]."

Regeneration Slow to Gain Traction

The rapid evolution of Asian economies over the last three decades has left many city centers with large volumes of aging or inappropriately zoned buildings. Regeneration is therefore a pressing concern, but in most cases it has been hindered by high costs. According to one consultant, "I don't think we've got our head around it yet at all in Asia, but ultimately the solution is going to have to be privately funded, probably using a public/private model. The land is valuable, but it's the compensation, the rehousing model—trying to avoid tearing down communities and moving them out to new towns, which has been very much the traditional model."

That said, public/private urban regeneration has become a big theme in Australia, moving light-industrial neighborhoods from inner-city areas to suburban precincts with good orbital road intersections that provide better distribution networks. Such projects are no doubt easier than in more densely populated cities in Asia because there is relatively little resettlement involved and the cost/benefit equation in a developed market makes the economics more compelling.

According to a locally based fund manager, “The zoning and infrastructure [are] creating the uplift in value that’s encouraging or enabling [the factories] to move, and then the combination and cooperation of public and private interests have allowed those areas to be regenerated. Now, putting major infrastructure into those areas for regeneration is very complicated, and they do require a partnership approach between large private sector balance sheets and local state and federal governments. They deal very hard and require a big commitment and a long-term vision. But there’s a lot of will in every part of the country to do those. So far, other than from a pure passive investment, we’ve not seen a lot of offshore organizations participate in that space.”

Conversion Plays Have Taken Off

Smaller-scale property conversion programs, meanwhile, have created significant amounts of new commercial and (especially) residential stock in city centers and suburbs. In China, for example, cities are entering into agreements with developers for conversion of farmland on city outskirts. According to one interviewee, “We design, form, and plan it; put in the infrastructure; and then hand it back to the city to sell. In return, they give us 10 percent of the area, or whatever they think is a fair price. We find that mayors welcome it as a model because it takes the onus off them, and they know in three years’ time they’re going to get a large tract of land back ready for sale.”

Conversion of city-center commercial buildings has also become a popular theme. Sydney and Melbourne are examples of this, with developers (often from China) buying B-grade office blocks for conversion into high-end apartments. One catalyst for this trend is worsening traffic congestion in cities across the region, which is creating a proliferation of city-center apartment and mixed-use projects.

However, rapid change can also have its downside, and this often revolves around planning permissions. According to one Sydney-based fund manager, much of the office stock bought with a view to conversion is now in limbo because buyers have miscalculated how to navigate planning processes. “The planning regime here is pretty different to China, so we’ve seen a number of those buildings bought with the intention of running down tenancies and getting vacant possession are

now actively being re-leased because the pathway to residential development consent doesn’t happen in just six or 12 months, and doesn’t automatically allow an extra 25 to 50 percent floor space on the site.” This also means that future sales of B-grade office assets are likely to slow. “I’m sure at some point in the future these will be viable conversion projects,” the fund manager continued, “but that won’t be in this cycle.”

In Melbourne, meanwhile, authorities have concluded for a variety of reasons that construction of too many new apartment towers in the CBD is unwelcome, leading to the introduction of a spate of rule changes in September 2015 that include height limits, mandatory setbacks, and new plot ratios. These changes are having a predictably negative impact on local land values and a correspondingly inflationary impact on home prices and rents.

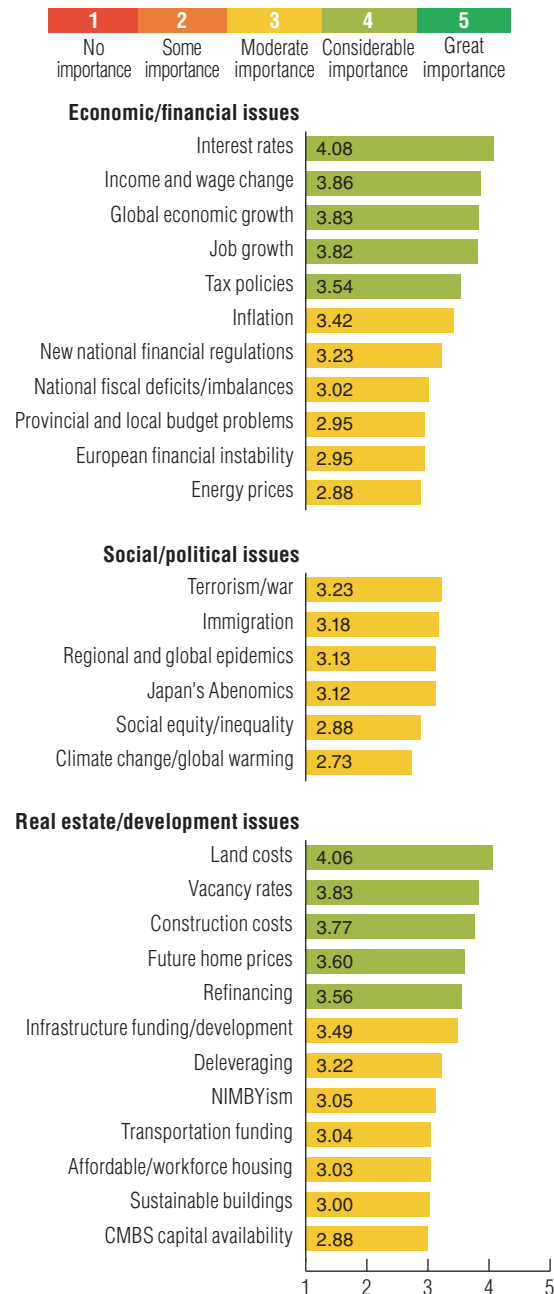
In Hong Kong, meanwhile, a government scheme to encourage conversion of aging industrial stock in East Kowloon has been in place for around five years, with the government waiving surcharges for conversions to (mostly) office use. Out of about 1,000 eligible buildings, more than 200 have applied to participate, with about half completing conversions. As one investor described the pricing dynamics: “You’re talking about an industrial building that might be leasing for HK\$7 to HK\$9 per square foot versus normal office rents in that location of HK\$35 per square foot. And in between you’re producing a revitalized office building that’s attractive to tenants at the right price points, which for us it was in the HK\$20-to-HK\$25 range.” With the scheme currently set to expire in early 2016, however, activity has slackened considerably.

Green Uptake Still Slow

The speed with which large volumes of existing stock have been converted in cities such as Sydney and Hong Kong underlines how government participation in such exercises is pivotal to their outcome. In the same way, government regulation is now the main driver for the adoption of green building practices in Asia. The problem is that most governments still do not take the issue seriously. According to one Hong Kong-based broker, “It seems to be a question of whether governments are going to promote or require it. We do have tenants asking about it, but if there’s nothing available they’ll still take a normal building. It seems to me that until you get a government like Singapore’s saying, ‘You have to meet this standard,’ then people aren’t going to do it.”

That said, more investment funds now regard green attributes as important criteria in assessing potential investments, either because they have adopted the standard themselves or because it is required of them by their limited partners (LPs), especially those from Europe. In addition, the cost-saving benefits are receiving greater recognition. As one

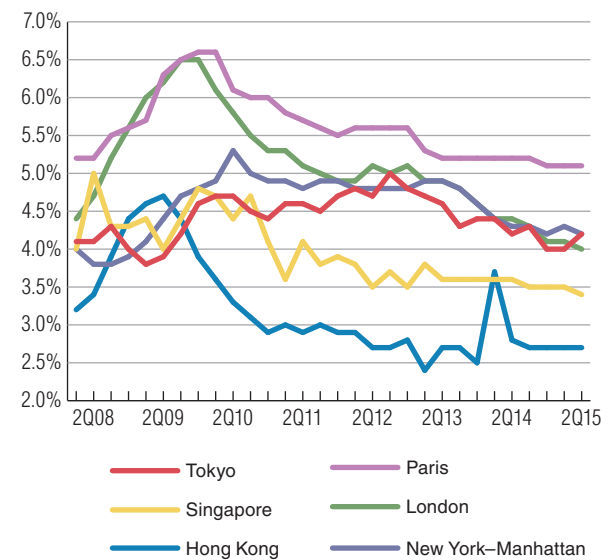
Exhibit 1-17 Importance of Various Issues for Real Estate in 2016



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

fund manager said, “We’re seeing more motivation to invest in environmental technology in our buildings because the economies are more attractive over the long term. So if you can get more high-tech about subdividing a/c [air conditioning] in the buildings or how to utilize the heat from the sun on the materials you use for the facades, you’re saving tremendous amounts. And as yields stay low, the more you can squeeze from being energy efficient, the more profitable the buildings can be. But you have to take a long-term view, so it

Exhibit 1-18 Top Office Quartile Yields by City: Rolling 12-Month Averages



Source: Real Capital Analytics, www.rcanalytics.com.

only applies if you’re willing to hold the buildings for ten to 15 years.”

While this has created some impetus for the greening of at least relatively new buildings, there has so far been little progress in promoting the retrofitting of older stock. According to another interviewee, “People understand that with a new building you can incorporate green features without it costing a lot more, but if it’s an old building they can’t be bothered to do anything about it unless they have to.”

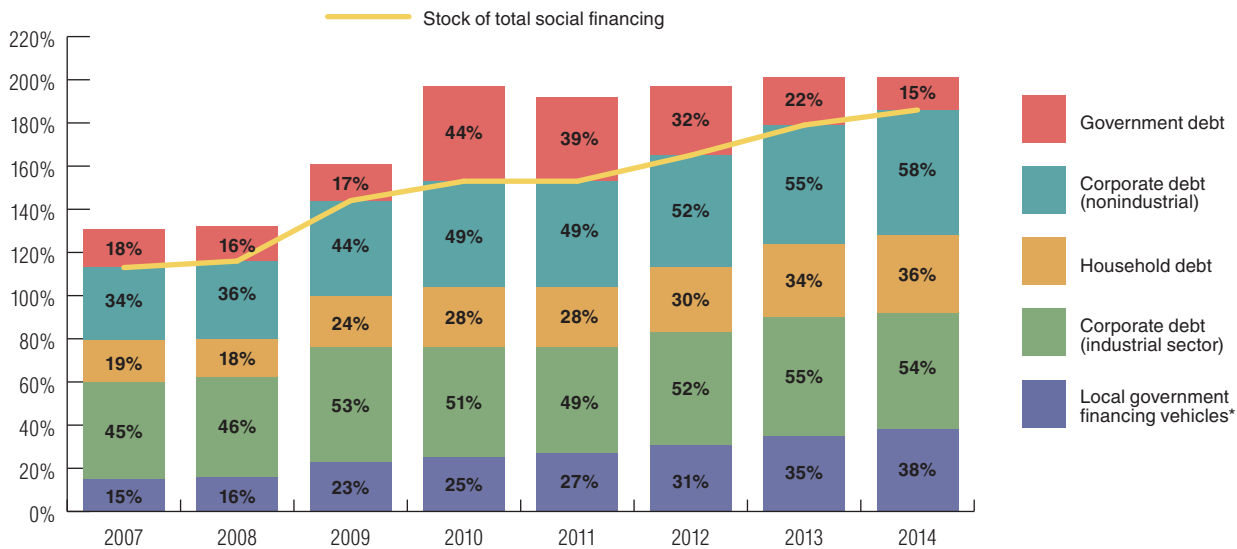
Biggest Risks

Profits for now may be strong, but they come against a backdrop of persistent risk, both globally and regionally. Of these, the most prominent include the following:

- U.S. base rate increase.** Regional markets (especially in Southeast Asia) tend to suffer disproportionately from both capital outflows and/or currency volatility when U.S. interest rates move up. This cycle is no exception, with major currency declines seen in the second half of 2015 in Malaysia, Indonesia, and Thailand at least partly attributable to U.S. rate increase expectations.

The other obvious concern about higher rates is their impact on both the cost of capital and the region’s tightly compressed cap rates. While the prospect of higher interest rates has been looming for years, most investors remain unfazed at current developments. To begin with, few expect to see significant, if any, increases in the near future. Indeed, with central banks in both China and

Exhibit 1-19 China: Credit Outstanding as a Percentage of GDP



Sources: RBS Macro Credit Research, International Monetary Fund.

*LGFV includes all local government debt, except local government bonds.

Australia cutting rates several times in 2015, the trend regionally points more toward easing than it does toward tightening. According to one fund manager, “Inflationary pressures are very benign globally—you could almost argue that deflationary pressures are stronger. So you do wonder what’s going to be the trigger that sends interest rates up. If you have a 150-to-250-basis-point increase, that starts to change things materially. But one 25-basis-point base rate rise doesn’t make any difference to anything, and given the current dialogue I find it hard to see what triggers a bigger rise, unless you start to see rapid wage inflation in the U.S.”

In addition, a rise in base rates does not necessarily translate into an equivalent increase in cap rates. That is because the spread between property yields and risk-free rates (i.e., sovereign bonds) is currently wider than the historical norm. So although a rise in base rates should be accompanied by a rise in the risk-free rates, significant room remains for that spread to compress back to normal levels before it has an impact on yields. As one analyst said, “In terms of closing the gap, all the heavy lifting has to be done by the bond market, because property yields haven’t moved as far off their long-term historical average as risk-free rates.”

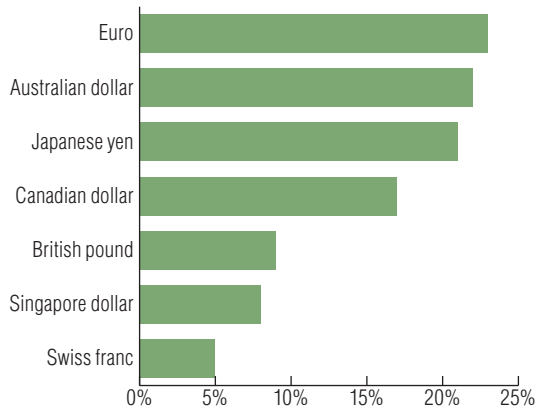
The same applies to the cost of capital. According to one Hong Kong-based investor, “Banks can afford to reduce their margin because with rates staying low for so long, banks have had an opportunity to increase their pricing. So once rates start to go up, the first thing that will hap-

pen will be that banks will absorb some of that into their margin.”

If this analysis is wrong, however, and rising interest rates do have an imminent and material impact on cap rates, which markets are most at risk? The consensus answer would be those markets where cap rates are most compressed—in particular Hong Kong and Singapore. As one analyst commented, “I worry most about Hong Kong, partly because it’s so volatile, but also because its economic cycle is very different from [that of] the U.S.A. So once the U.S. rates increase, Hong Kong will do the same. But the U.S. is in recovery mode, while Hong Kong is now peaking—the different economic cycles could make it a big issue.”

- **China’s economy.** The potential for an economic hard landing in China has been another factor regularly cited in *Emerging Trends* surveys. Once again, in 2015 “it’s the big risk, upside or downside,” and particularly so this year given conspicuous weakness in recent Chinese macroeconomic data. The crash in China’s stock markets in mid-2015, while neither cause nor effect of the slowing economy, has done nothing to steady nerves. While a detailed analysis of China’s economy is beyond the scope of this report, it is fair to say that concern revolves mainly around three key vulnerabilities:
 - A large debt overhang that is hard to quantify but which jumped, according to the International Monetary Fund (IMF), to 193 percent of gross domestic product (GDP) in 2014, up from 120 percent in 2008.

Exhibit 1-20 Percentage Change in Strength of U.S. Dollar Relative to Other Currencies, 2Q 2014 to 2Q 2015



Sources: Real Capital Analytics, www.rcanalytics.com, October 2015; xe.com.

- An overreliance on investment as a component of GDP growth.
- The risk that implementing reform may lead to a sharp contraction in demand.

GDP growth fell to 7.4 percent in 2014, according to official figures, and is expected to fall further to some 6.8 percent in 2015, according to IMF projections.

What are the implications for real estate investing? This question in itself leads to yet another vulnerability, because the immediate answer is that China's economy is a "black box" that resists analysis from the outside. What is clearer, though, is that most investors with local knowledge of the market remain fairly positive about the prospects for the economy over the short to medium term. According to one: "That's one of the benefits of central government—in a command economy they still have enough levers to pull." According to another: "I think the headline numbers are not particularly useful. The drama that's attached to a report of 6.9 percent versus 7 percent [growth] is pointless because nobody knows what the number really is. But as you spend time in China, it's pretty obvious that there continues to be genuine economic growth, and I think as long as those headline numbers are somewhere between 5 percent and 7 percent, we shouldn't worry about it too much, because even at 5 percent the absolute volume of growth is huge."

- **Currency Movements Threaten Profits.** Over the last several years, the U.S. dollar has appreciated significantly against most Asian currencies. With volatility peaking in the last 12 months, these movements have had a real

impact on profitability for U.S. dollar-denominated funds. As one fund manager commented, "If you are U.S. dollar-based, it's nice that cap rates have come down and you can sell and make good local-currency profits. But the counter to that is obviously currency, because when you convert it back to dollars you get shellacked. So it's been a bit of a wash."

While fund managers are quick both to disclaim expertise as currency traders and to point out that foreign-currency deals can be protected by hedging, the generally high cost of such protection, together with the extent of the recent volatility, has now made it a key consideration in investment decisions.

To a certain extent, these concerns may be moot given that most of the currency declines may have already occurred, with further movement more likely on the upside than the down. Still, history has proved that exchange-rate fluctuations are hard to project with any accuracy, and with many developing market economies also challenged by similar instability in global commodity prices, the potential combination of macroeconomic problems, capital outflows, and currency depreciation creates a volatile cocktail that only adds to the uncertainty. This is especially so given that regional markets (especially in Southeast Asia) tend to be more exposed to currency fluctuations when speculation over U.S. interest rate tightening is high. With the focus on U.S. base rates likely to remain front and center for at least the next 12 months, the possibility for more volatility over the near term remains high.

Real Estate Capital Flows

“Outgoing capital is one of the **biggest stories** in our industry that we’re experiencing year by year. Over five years, it’s going to be massively crazy.”

The big story in terms of regional movement of capital this year has been the ongoing migration of money from Asian markets into real estate assets elsewhere in the world, as both institutions and private investors seek more diversification and higher profits. As a result, the volume of capital leaving the region increased by almost 60 percent year-on-year in the first three quarters of 2015, according to Jones Lang LaSalle, as investors look increasingly to the United States and Europe as sources of new deals. Incoming capital, meanwhile, remains on a par with 2014 levels, with declining volumes of private equity capital canceled out by an increase in funding introduced by institutional and sovereign funds.

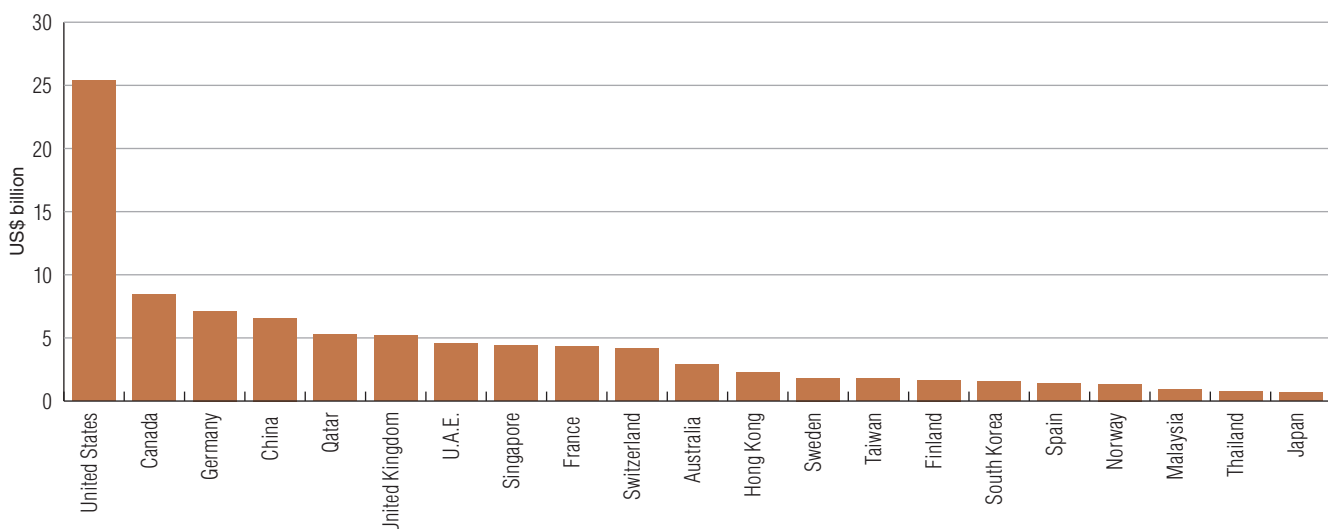
Outgoing Capital Is Up Big

Cash outflows from Asia are a continuation of a trend that began around two years ago. What is different, though, is the

volume—this year, the exodus is stronger than ever, and shows no sign of easing. As one fund manager put it, “If we have this conversation in five years’ time, we’re not going to look back and say, ‘Mother, that was a lot of capital coming out of the region in 2015.’ Because in 2020, I think it’s going to be so much larger—outgoing capital is one of the biggest stories in our industry, that we’re experiencing year-by-year. Over five years, it’s going to be massively crazy.” Flows are driven by the huge amount of capital accumulated by Asian sovereign wealth funds, pension funds, and insurance companies, most of which is still invested in bonds or other low-yielding investments.

The biggest contributors to this outflow continue to be the Chinese, who are currently responsible for about 25 percent of all Asian commercial real estate outbound capital. According to brokers CBRE, Chinese capital inflows into U.S.

Exhibit 2-1 **Top Sources of Cross-Border Capital in Global Commercial Real Estate by Buyer Origin, First Half of 2015**

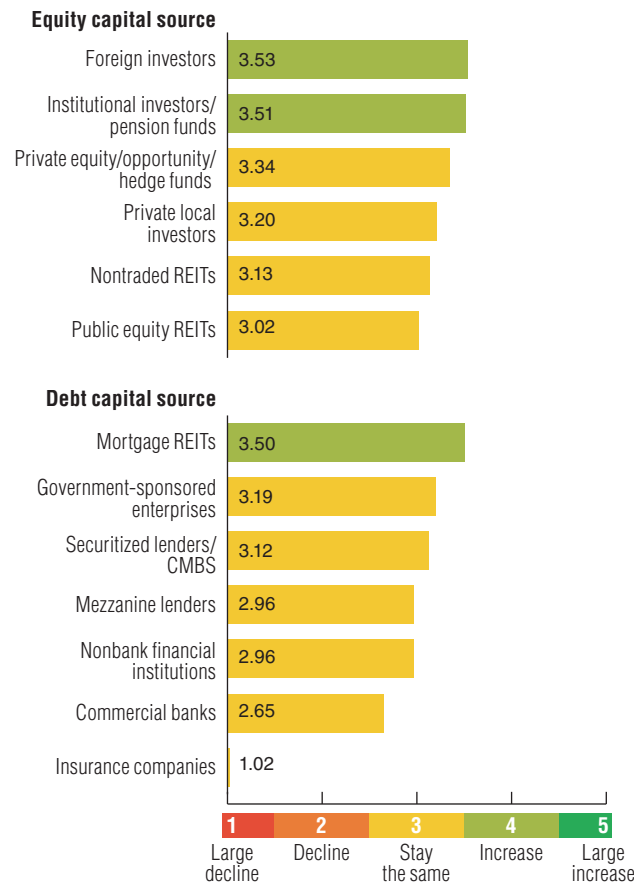


Source: CBRE Research, Real Capital Analytics.

real estate of US\$3.7 billion in the first half of 2015 were almost four times higher than the equivalent figure in 2014, with most investors targeting development sites rather than completed assets. Residential is in general the preferred sector, although investments now run the gamut of asset classes. The other big exporter of Asian capital in 2015 has been Singapore. The city-state has a traditional role as an aggregator of global funds, but recently it has also been a large exporter of funds in its own right, with local property companies, real estate investment trusts (REITs), and investment funds currently finding little appeal in their home market.

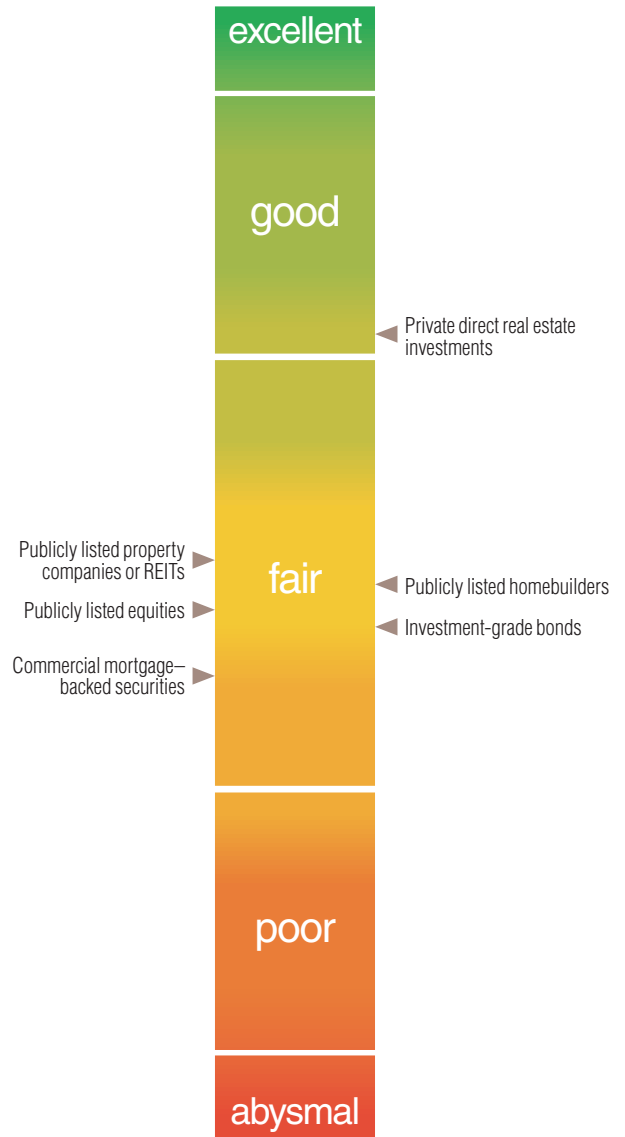
In September 2015, Chinese authorities began implementing new policies aimed at stemming currently high levels of capital flight from the mainland that are having a destabilizing effect on the Chinese yuan. While these policies, which include restrictions on outgoing capital transfers by banks as well as higher transaction fees, are unlikely to have a significant impact on institutional or corporate investment, they have led to speculation that international property purchases by individual buyers may be curtailed. This would have a significant effect on overall flows because private capital rep-

Exhibit 2-2 Change in Availability of Capital for Real Estate in 2016



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Exhibit 2-3 Investment Prospects by Asset Class for 2016



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

resents such a large proportion of the total. It is still too soon to assess how the situation will unfold, but based on the limited evidence available at the time of press, interviewees doubted that the policy change will be material.

So far, Asian investors' track records abroad have been mixed. A lack of experience in navigating the pitfalls of unfamiliar markets—especially when dealing with local planning rules and bureaucracies—has caused unanticipated delays. In addition, there are persistent reports of Asian buyers overpaying for assets. To be fair, these are the types of issues expected to face any investor entering new markets. As one Australian fund manager commented, "Most Chinese orga-

Exhibit 2-4 Largest Public Funds

Rank	Fund	Country	Type	Assets as of June 2015 (US\$ billion)
1	Social Security Trust Fund	United States	National pension	\$2,789.5
2	Government Pension Investment Fund	Japan	National pension	\$1,150.0
3	Government Pension Fund—Global	Norway	Sovereign wealth fund	\$882.0
4	Abu Dhabi Investment Authority (ADIA)	United Arab Emirates	Sovereign wealth fund	\$773.0
5	China Investment Corporation (CIC)	China	Sovereign wealth fund	\$746.7
6	SAMA foreign holdings	Saudi Arabia	Sovereign wealth fund	\$671.8
7	Kuwait Investment Authority (KIA)	Kuwait	Sovereign wealth fund	\$592.0
8	SAFE Investment Company	China	Sovereign wealth fund	\$567.9
9	National Pension Service of Republic of Korea	South Korea	National pension	\$455.0
10	Stichting Pensioenfond ABP	Netherlands	Public pension	\$440.0

Source: Sovereign Wealth Fund Institute.

nizations and people I've dealt with over the last few years take a long-term view, perhaps much longer-term than most Australian investors, so I don't feel they are doing anything irrational." According to another interviewee, "Certainly, in terms of pricing, the Chinese are leading the way. But the bulk of the buying has been into residential, where they can see an exit, so from that point of view they're being quite savvy. And also, they're buying into markets where supply is tight. They may be paying some element of tomorrow's price, but there is the prospect of further growth in values, so they're doing their homework."

Big Money Still to Come

Although Asian capital exports so far have been huge, there is probably much more still to come. To begin with, many Asian financial institutions have either no allocation to real estate or have yet to export capital at all. Of those that do, allocations average just 2 percent, compared with between 4 percent and 6 percent globally.

Chinese insurance companies, for example, have already made some major international commitments, but still have vast and growing asset bases to invest. Recently, Jones Lang LaSalle estimated that Chinese insurers could collectively export as much as US\$240 billion to international property markets over the next ten to 20 years, making them some of the biggest institutional investors in the world.

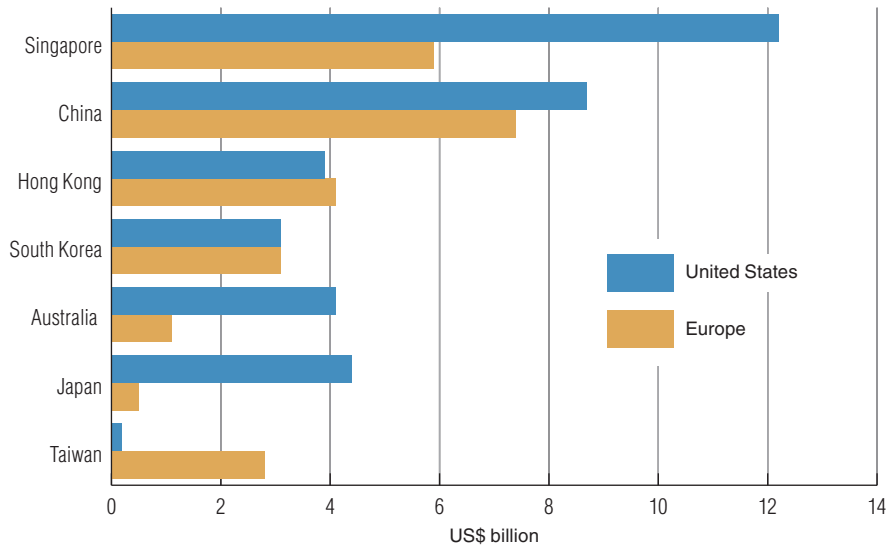
In addition, those countries with arguably the most capital to contribute to the outflow have yet to participate significantly. One nationality so far conspicuous by its absence is Japan. Japanese pension funds—in particular the US\$1.2 trillion Government Pension Investment Fund (GPIF)—are some of the largest in the world, but have been inwardly focused for years, investing to a great extent in low-yielding Japanese government bonds (JGBs). That is set to change, however,

partly because they need to generate higher returns as Japan's rapidly aging population begins to tap into savings, and partly because Japanese government purchases of JGBs as part of the government's current quantitative easing program have been so massive that no JGBs are left on the market to buy. Although an announcement in October 2014 indicated that the GPIF—and, by extension, the other funds—will restructure portfolios to create an allocation of 5 percent to alternative assets, including real estate, there has so far been no sign of activity on international real estate markets. They probably will not take long to appear, however. In interviews, a number of managers at Japanese funds outlined plans to invest more funds internationally, especially in the United States. As one institutional fund manager said, "We haven't seen the Japanese much yet, but I'm sure they're coming."

Despite a chronic shortage of domestic stock, Australian capital also has been slow to reappear on international markets, mostly because of the damage the local REIT industry suffered due to international excursions (primarily in the United States) during the last cycle. To an extent, though, this is now changing, too. Some US\$2.9 billion in Australian capital was invested in cross-border real estate in the first half of 2015, according to CBRE, most of it coming from the country's largest pension fund, AustralianSuper, which has made a series of purchases in the United States and the United Kingdom. The fund has indicated that it is unlikely to invest in Asia.

While further international investments by Australian pension funds are likely, however, the REITs seem unlikely to venture offshore again anytime soon. "Most of them have been selling out of their foreign investments for the last five years," said one former REIT manager, "so it would be hard to persuade them to go directly offshore now, and a REIT's not going to go and buy assets that are managed by someone else. The second thing is that once you go to a market and you leave, it's very hard to go back to that market and be taken seriously. It would

Exhibit 2-5 Asia Pacific Investment Flows to the United States and Europe, January 2014 to June 2015



Sources: Jones Lang LaSalle, Real Capital Analytics, www.rcanalytics.com.

be a brave CEO of a publically listed Australian REIT to say they're going to have an offshore strategy again."

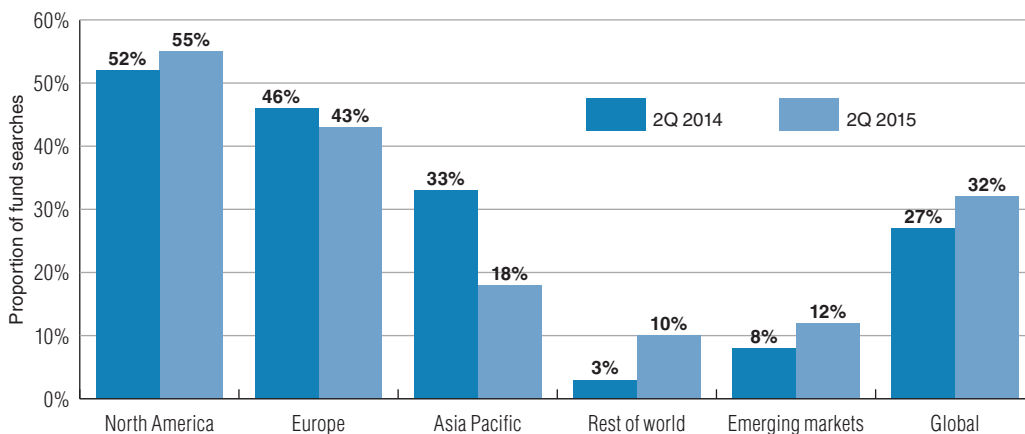
United States Attracts the Most Capital

In 2015, Asian flows to the United States have accelerated, with outbound capital increasing 36 percent year-on-year in the first three quarters, according to Jones Lang LaSalle. Asian flows to Europe, meanwhile (some 80 percent of which are targeted at London), fell 6 percent during the same period. This is partly a result of impending interest rate increases in the United States drawing in more capital, partly a reflection of the weakening economic outlook in Europe, and partly a

realization that the easy money from European distress has already been made.

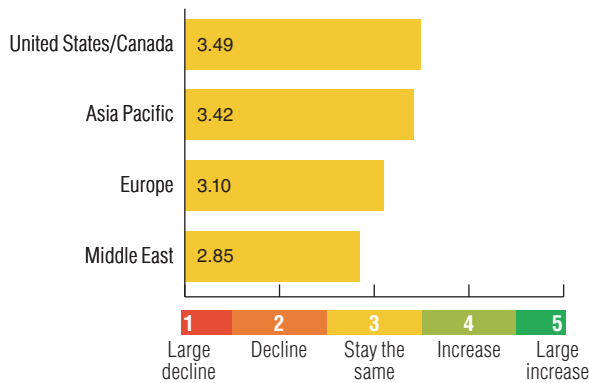
In any case, direct investments in gateway cities continue to be the focus, although as more investors crowd into these locations and cap rates compress further, willingness to move to secondary cities and to invest with local partners is now increasing. In addition, Asian investors are beginning to invest in U.S. real estate via fund structures, giving them access to diversified, well-managed property bases, as well as a more efficient tax structure.

Exhibit 2-6 Regions Targeted by Private Real Estate Investors in the Next 12 Months, 2Q 2014 versus 2Q 2015



Source: Preqin.

Exhibit 2-7 Change in Availability of Equity Capital for Real Estate in 2016 by Source Location



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Incoming Flows to Revive?

The volume of capital coming into Asia from outside, meanwhile, has stalled at roughly the same levels as in 2014, even as flows to Western markets have increased significantly, driven largely by higher risk-adjusted returns. In particular, data show a significant recent decline in private equity fundraising for Asia (see exhibit 2-6), although that deficit has been filled by a corresponding increase in incoming capital from global sovereign wealth funds and institutional investors.

Recent weakness in incoming flows may be about to change, however. According to CBRE, fundraising increased during the first half of the year, with several major funds seeing final closes that exceeded targets, as European and (especially) U.S. institutions continued to allocate capital to the region (see exhibit 2-7).

The tempo then slowed in the second half. According to one Hong Kong-based fund manager, this was “partly because of the stock market gyrations in August, and also because of a general sense that China is slowing, and that it’s going to impact the region.”

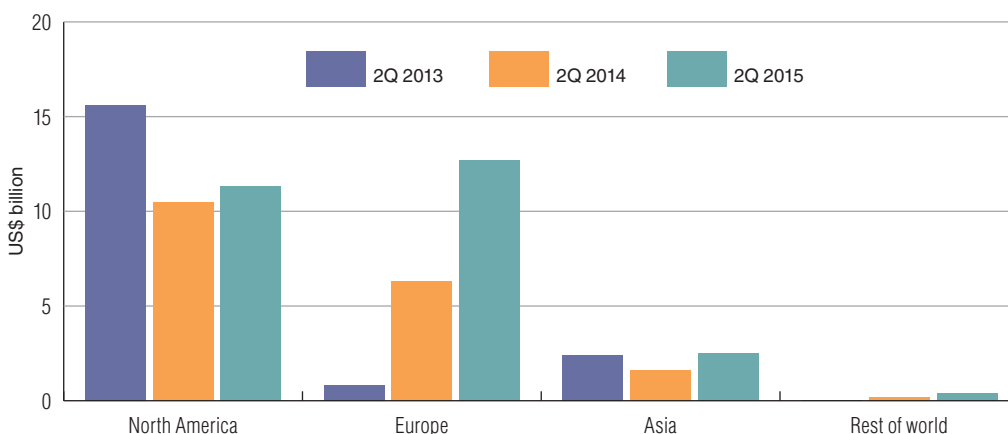
Still, the bigger picture presented by interviewees is for a resumption of normal service. “The U.K. and U.S. are less attractive,” said one broker, “so capital is coming back to Asia looking for deals.” Also, according to a Hong Kong-based manager at one global fund, “There is more money [heading here] today from the U.S. and Europe than was the case three or four years ago, and I think that’s partly because the more obvious trades in North America and Europe have been made. So it’s harder to see value there and easier to see growth here, even though it’s expensive. Here, you have more of the fundamentals supporting your investment thesis than you have in, say, Europe, where we’ve seen massive increases in value by capital coming back in and repricing the risk.”

China Dominates Intra-Asian Flows

Intra-Asian flows fell by some 40 percent in the first half of 2015, according to CBRE. According to CBRE, as investors increasingly target Western markets, assets become harder to source, and today’s large deal sizes require more time to finalize. However, a strong pipeline of upcoming platform and portfolio deals is expected to boost intra-Asian investment flows by the end of the year.

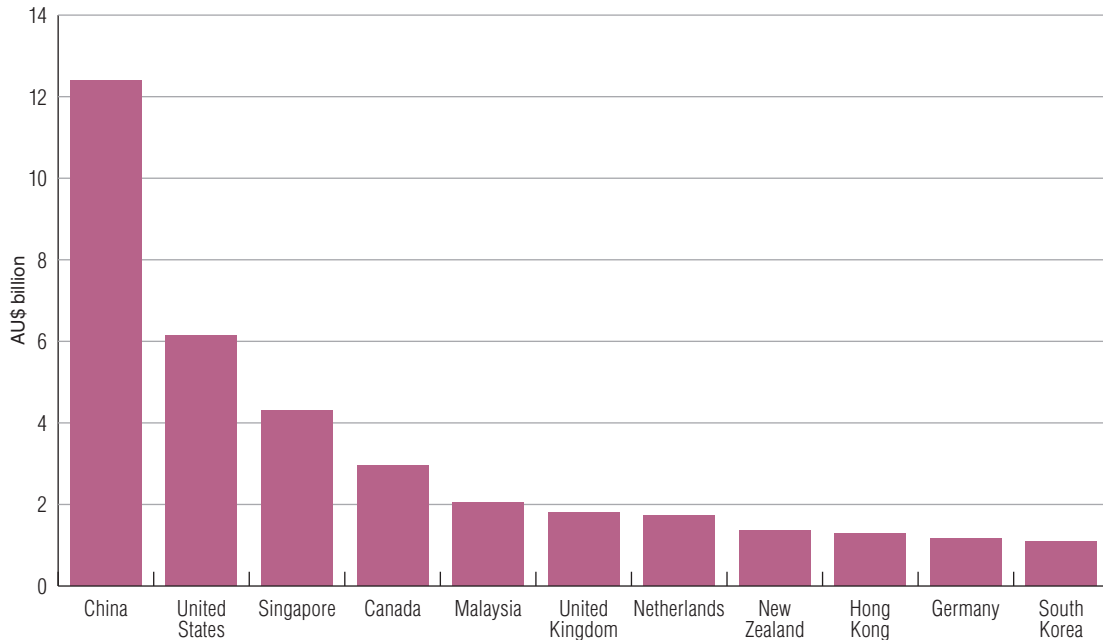
China, unsurprisingly, is the biggest exporter of capital within Asia, followed by Singapore. So far, Australia (and in particular Sydney) has been the biggest recipient of these flows, but capital is increasingly diversifying to other markets. According to one analyst, “To an extent, China has filled its boots down

Exhibit 2-8 Closed-End Private Real Estate Fundraising by Primary Geographic Focus, 2013 to 2015



Source: Preqin.

Exhibit 2-9 Largest Foreign Investors in Australian Real Estate Sector, Year Ended June 2014



Source: Australian Foreign Investment Review Board.

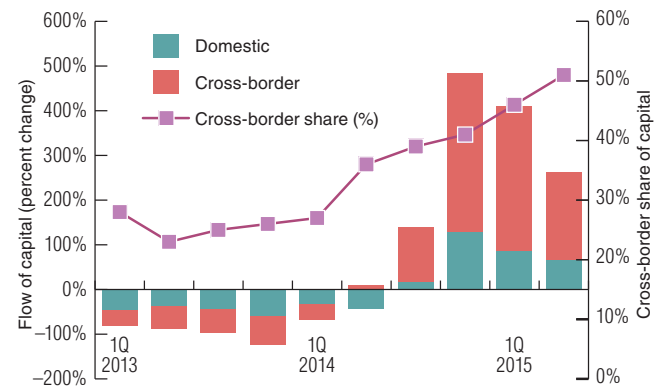
in Australia and is now starting to look at other locations in the region, especially in Japan.”

Outgoing investment from China is at times so heavy it can distort markets where it is sent. In particular, current levels of capital directed to Australian real estate in the first half of 2015 dwarfed that received from other countries. (See exhibit 2-9.)

This may not be a problem at the institutional and private equity levels, but increased private purchases of Australian residential properties have generated controversy. The AU\$8.7 billion spent by Chinese investors on Australian residential property for the year ending June 2014 was a 60 percent increase year-on-year, and accounted for some 15 percent of new-home sales by value in Australia for the year, according to investment bank Credit Suisse. While this is mostly focused on the top end of the market, it has led some to suggest it is contributing to the rapid rise in housing prices in Australia’s big cities.

Whatever the truth of that, following the lead of the governments of Hong Kong and Singapore in previous years, Australian authorities announced in February 2015 the introduction of new restrictions as well as more active enforcement of existing rules aimed at limiting foreign purchases of Australian homes. The issue continues to generate controversy, however, with critics suggesting the rules are still not being actively enforced.

Exhibit 2-10 India: Change in Capital Sources, Rolling 12-Month Average



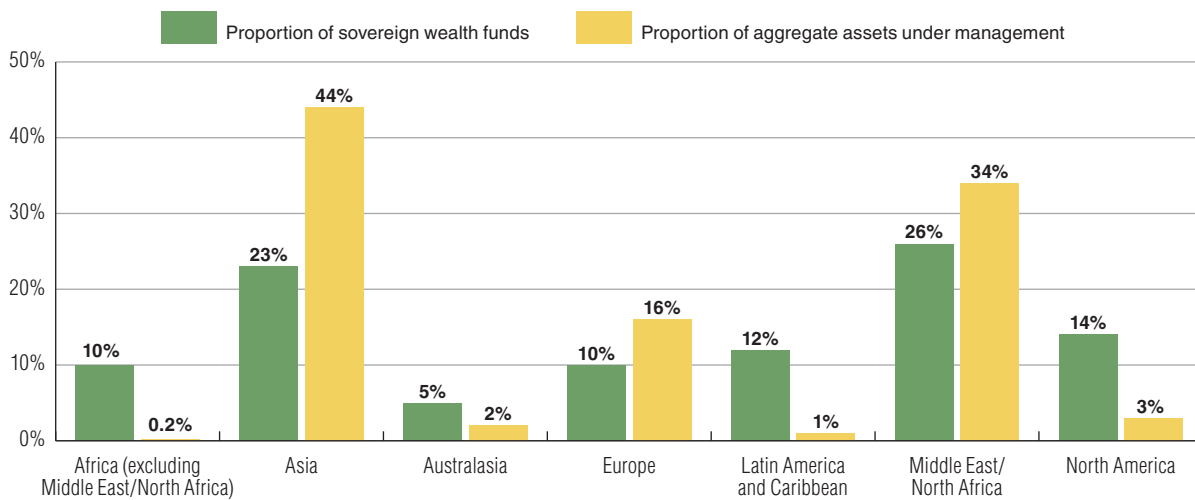
Source: Real Capital Analytics, www.rcanalytics.com.

India Regains Favor

Also within Asia, flows of foreign capital to India began increasing dramatically at the end of 2014, with the amount invested growing by almost 200 percent year-on-year by the middle of 2015, according to data providers RCA.

Cross-border funds accounted for more than 50 percent of all investment activity in India during that period, compared with just 26 percent for the whole of 2013—a remarkable renaissance in foreign investor interest.

Exhibit 2-11 Sovereign Wealth Funds by Region, 2014



Source: 2015 Preqin Sovereign Wealth Fund Review.

According to one Delhi-based consultant, there are various reasons. First, the government reduction in the minimum size of built-up areas required of foreign investors, from 50,000 square meters to 20,000 square meters (538,000 to 215,000 sq ft) has led to “increasing confidence among institutional investors they can find an exit—because even if they can’t find a foreign investor to sell to, they may still be able to liquidate by selling to locals.”

Second, because Indian developers—especially in the north—are currently “scraping the barrel even to make monthly expenses,” foreign investors have bought at good prices, with office space mostly picked up at close to or lower than depreciated replacement cost. As a result, a handful of foreign private equity funds are now some of the biggest cor-

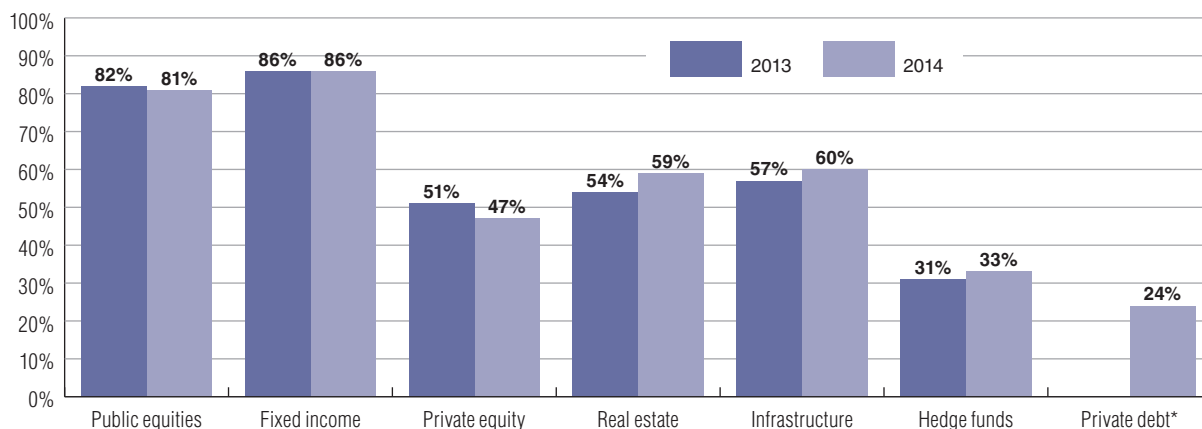
porate real estate owners in India, after starting from scratch in 2011–2012.

While many investors therefore remain wary of Indian markets given the losses suffered by the first wave of funds that moved into the country in 2006–2007, the recent success stories indicate that “they have now learnt from their mistakes—this time around I’m pretty certain they will make money and that this will, in turn, allow India to be seen as a more credible investment destination.”

Sovereign and Institutional Capital Still Growing

Over the last couple of years, one of the big stories in Asian real estate has been the increase in institutional and sovereign

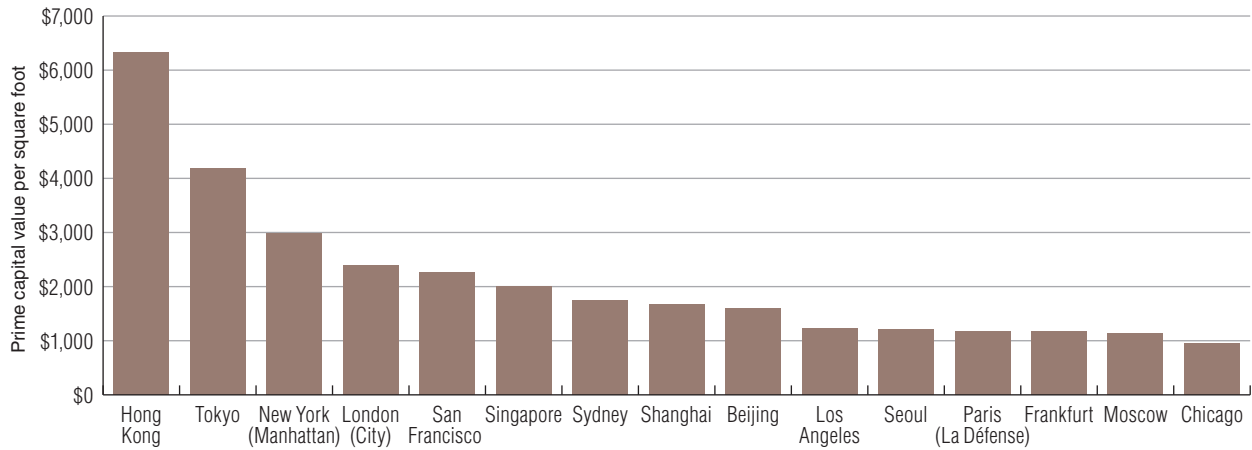
Exhibit 2-12 Proportion of Sovereign Wealth Funds Investing in Each Asset Class, 2013 versus 2014



Source: 2015 Preqin Sovereign Wealth Fund Review.

*Data only available for 2014.

Exhibit 2-13 Skyscraper Index



Source: Knight Frank, *Global Cities: The 2015 Report*, Autumn 2014.

fund money now actively targeting Asia. Much of this newly arrived capital hails from the Middle East, including Qatar and Abu Dhabi, with more coming from Europe, in particular Norway and the Netherlands. In addition, there continue to be large increases in allocations of capital coming from Asian sovereign wealth funds (especially China) as well as from institutional sources such as regionally based pension funds and insurance companies.

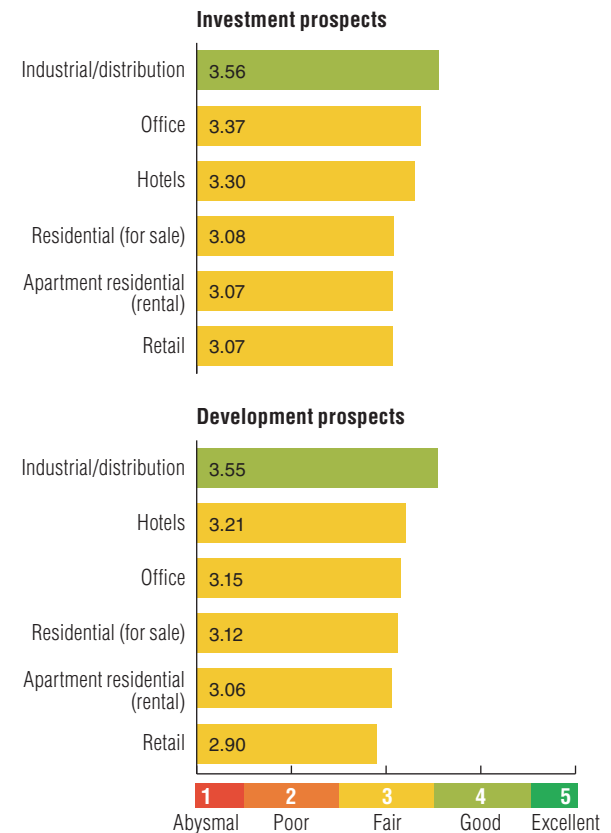
To a certain extent, this simply reflects increasing amounts of capital piling up on the sidelines of newly enriched Asian economies. Beyond that, however, it also reflects a changing regulatory environment where authorities recognize that defensive investments in local bond markets or other local assets are not providing good enough returns, and may also be actively distorting local markets. This has been the inspiration for economies such as South Korea and Taiwan to allow or force pension funds and/or local insurance companies to begin investing abroad.

Institutional Money Changes Dynamic

The emergence of so many institutions—especially the home-grown players—in Asian markets has changed the investing dynamic in various ways.

First, investments tend to be longer-term (in the case of institutional buyers, ten to 20 years). Second, as already noted, it has led to increased competition in the core space, which in turn contributes to the downward trend in cap rates. According to one fund manager, “Just to pick an example, the Chinese insurance companies’ perspective of risk in China and their cost of capital relative to a U.S. pension fund is very different. They will look at an office building in Shanghai as being relatively low-risk, and their cost of capital is basi-

Exhibit 2-14 Prospects for Major Commercial Property Types in 2016



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

callly free at the moment. So, they can afford to pay, quite reasonably, a much higher price than a fund of offshore investors managed by somebody like us.”

Third, it means that development is now relatively easier to fund. Historically, outside major markets such as Japan and Australia, there has been a shortage of long-term equity capital that investors could count on as an exit for their trades. Today, however, “that’s changed, and it’s a real structural change. So you can reasonably now develop high-quality office, retail, hotel, and residential for rent, and if you can manage it well, you don’t have to strata the floors. You don’t have to flood the units because there is an exit to a domestic and, in most cases, institutional investment market. That didn’t exist as recently as five years ago in most markets, and certainly not in China, and even in places like [South] Korea and Malaysia. So I think that does change the dynamic as to the sort of risk you’re taking by taking on a large commercial development.”

Bigger Deals

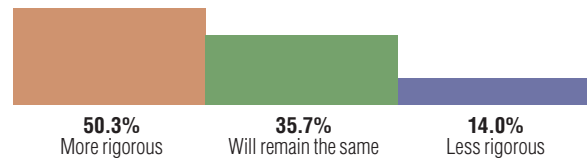
Finally, deals are getting bigger. There are two reasons for this. First, fund size is increasingly dictating access to the best deals. According to one fund manager, “The markets are harder. China’s probably the poster child for it, but up until 2010 it was kind of hard to lose money. Today, that’s all changed, so the next cycle of investing in real estate is all about differentiation—whether it’s the quality of the partner, the quality of the project, or the quality of the product you’re delivering, it needs to be fit for purpose. And what we see in the bigger markets is that to get that—to get the right partner that has the brand, that has the right projects—you have to go bigger, to the flagships of these groups. So you need to write a bigger check to be meaningful.”

The other reason is that the appearance of so many big new investors competing for deals means that the amount of new capital in circulation has outstripped the stock of assets available to buy. As a result, “a lot of the big investors are now very focused on platform or partnership-style investing.” This has led to growing numbers of high-value deals recently, often involving a big local developer.

Platform deals enjoy obvious advantages of scale. In addition, they allow for access to a type of blue-chip asset base that otherwise simply is not available on a piecemeal basis, if at all. There also are drawbacks, however. According to one fund manager, when a fund buys at this level, “to some degree you’re no longer talking about real estate, it’s more a corporate/operational-type investment where probably fundamentally you’re running a business. So it’s one thing if you get into a platform for nothing and you have access to XYZ. It’s another thing if you have to pay for the platform itself to get to the asset.”

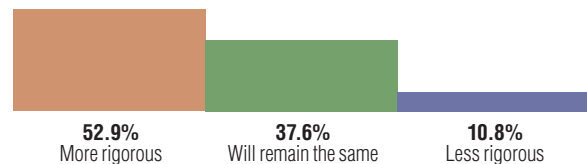
The same concern was echoed by another fund manager, who said, “We have relationships already with developers where they offer us deals—there’s this flow that comes in. So

Exhibit 2-15 Equity Underwriting Standards Forecast



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Exhibit 2-16 Debt Underwriting Standards Forecast



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

we know that our interests aren’t necessarily aligned because what may be good for their business means that not every individual deal they do is underwritten on economic terms—it may be a bit of a loss leader, for whatever reason. Well, I don’t want to be investing in a loss leader if I have a choice. So if you’re going to just sit back and say, ‘I’m going to do every project that you’re going to do, I’m not going to have any oversight over it,’ or, ‘I’m going to have oversight, but I don’t really have the capability to oversee because I’m not here,’ or, ‘I don’t have a big enough team,’ or, ‘They don’t know enough,’ how are you going to protect your interests?”

Club Deals and Separate Accounts

Another change brought about by the market’s evolving investor mix is that big funds are increasingly collaborating to set up deals. According to one analyst, “The volume of capital that needs to be deployed means that deal sizes are getting bigger. But beyond that, the concentration of risk and need for diversification means you then get two or three entities combining to take out some of these deals.”

These partnerships can form in different ways. One option (described as “one of the biggest trends we’re seeing”) is for institutional and sovereign buyers to form clubs and buy directly, rather than via a locally based fund, often with one investor taking the lead. According to one interviewee, “It’s something we’ve talked about for a couple of years, but it’s starting to pick up now. Post–global financial crisis, I think there was a desire for greater control, meaning people are looking to be more in control of their own destiny, dealing with fewer partners in a club and with more direct control. That doesn’t mean they don’t have a manager alongside them, but they definitely want more control.”

The other option is to use separate accounts, with investors able to pick and choose between deals using money placed with fund managers. While these are also popular, they are again not without drawbacks. According to one fund manager who operates separate accounts with institutional investors, “The problem with the pure separate account with no commitment is that there’s still a manager, even though he’s putting a lot of capital in. These guys take too much time. We have a lot of people who bring us deals, big deals, and when we take it to [the institutional investors], they go, ‘OK, I need six months.’ That just doesn’t work.”

Another fund manager said, “People like to think they want to invest [through separate accounts], but they are very rarely able to structure them unless they have a history of having done it. U.S. public pension funds, for example, have a strong history of separate account investing. So in that environment, you can set up a relationship where you can be competitive, make investments, have a process that could build a portfolio. But many investors who don’t have that history and don’t have the staffing to do it often find themselves frustrated because they can’t be competitive—they don’t have a process behind that strategy that supports it.”

Family Offices Move Fast

One of the consequences of so much private wealth now in circulation globally is the growing volume of high-net-worth (HNW) capital controlled by family offices. By nature, the activities of these groups are hard to track, but anecdotal reports from around the region suggest that Asian-based family offices are becoming ever-bigger players. According to one broker, “You’d be surprised. In Hong Kong, if you forget the megadeals and look at the majority of transactions, they are completed by family money—without it, the brokers would starve to death.”

Today, HNW capital in Asia is increasingly active on a cross-border basis (in particular to the United States) as second-generation family members, often Western-educated, take more control of investment decisions. Retail and hotel investments are popular themes, with investments tending to be long-term holds. One investor described them as “very

opportunistically driven, very savvy. They act fast and don’t go for the trophy buildings—price dislocation, rescue capital, that’s what they want.”

Even though they fly under the radar, they probably represent a significant proportion of Asian outgoing capital. Interviewees described family offices that were involved in investing in Asian frontier markets, buying retail units in Tokyo, or building speculative residential developments in U.S. university towns, “then marketing them straight back into China or wherever they come from.” Another interviewee in Australia described Chinese private capital in the fringes of Sydney “buying old warehouse and getting it rezoned, then converting it to mixed-use apartments with a bit of ground-floor retail. You read about it in the paper quite a bit, these investments in obscure places and you wonder how they even heard of it.”

Banks Still First Choice for Debt

While statistics suggest that bank lending growth in Asia has declined in recent years, from an average of 15 percent annually in the period leading up to the global financial crisis, to just 7 percent in the last few years, the reality on the ground is that bank debt remains cheap and is readily available for development projects in most markets around the region. Together with proceeds from presales, bank debt remains the dominant source of financing for Asian real estate.

Certainly, movement around the margins has occurred. In Japan, for example, access to bank debt has today become easier than ever, with LTV ratios of up to 90 percent possible at rates of 200 to 250 basis points. In Hong Kong and Singapore, however, government regulations have set limits on lending terms, in particular relating to LTV ratios. These are having a significant impact on the availability of consumer mortgages, but the impact on investment funds has been minimal.

According to one Hong Kong-based fund manager, “Hong Kong and Singapore banks are still keen on real estate. LTVs are to some extent prescribed in Hong Kong, with a cap at 40 percent. But most banks are still comfortable at 50 percent, which means they’ll probably lend you 40 percent plus another tranche for capex, which might amount to 10 percent

Exhibit 2-17 Typical Commercial Property Bank Lending Terms in Major Markets, Second Quarter 2015

	LTV ratio (pre-global financial crisis)	LTV ratio (current)	Cost of financing
Australia	65%–70%	60%–65%	3.4%–4.0%
China	50%	50% or below	6.3%–7.3%
Hong Kong	70%	40%	2.7%–3.2%
Singapore	60%–70%	50%–70%	2.8%–3.3%
Japan	75%	65%–85%	0.6%–1.4%

Sources: CBRE Research, S&P Capital IQ, and various central banks and monetary authorities.

of the property value. And they're keen to lend, I think they're comfortable with the macroenvironment, although some of them prefer office, some of them prefer other sectors."

That bank-lending policies remain in general so loose is perhaps surprising given that markets are widely anticipating hikes to the U.S. base rate, which will directly or indirectly affect lending terms and availability of capital in Asia. Many international banks already are tightening their own lending terms even as local lenders stand pat. According to one banker, "We are upping our rates, but until the local banks in any of these markets are on the same playing field, it's really challenging. They don't seem to have the same concerns over Basel requirements that the big banks have. We get asked by investors a lot, but very rarely will our own debt guys finance something we've bought, because local debt is so much cheaper and has fewer covenants. From an investment perspective, it's still pretty user-friendly."

The same applies in China, which, together with India, has the tightest credit environment, at least on paper. According to one banker lending into China, "We have [numerous] lending relationships there, so we know intimately what's going on. And from a debt perspective, they're still getting credit lines. So what's happening, I think, is that overall credit isn't pulling back that much, I think it's just being allocated to the top guys. The money is being pulled back [from the weaker players] and it's being given to them. So I think there will be winners and losers now."

One trend that has emerged over the last 12 to 18 months is increasing activity by international banks—whether in China, Japan, or Australia—offering longer tenor than the traditional three- to five-year terms. According to a Sydney-based fund manager, "The Aussie banks in the past have only been

willing to lend on three- to five-year facilities, and even to get five-year has been a challenge. But now we're seeing other participants from Japan, Europe, the U.S., and Canada all willing to do far longer-dated debt—so seven to ten years at 125 to 130 bps [over the three-month Bank Bill Swap Rate]. The only way we've been able to access that tenor previously has been through a medium-term note offer." As a result, domestic banks in Australia have now been forced to offer the same terms.

Limited Scope for Mezzanine

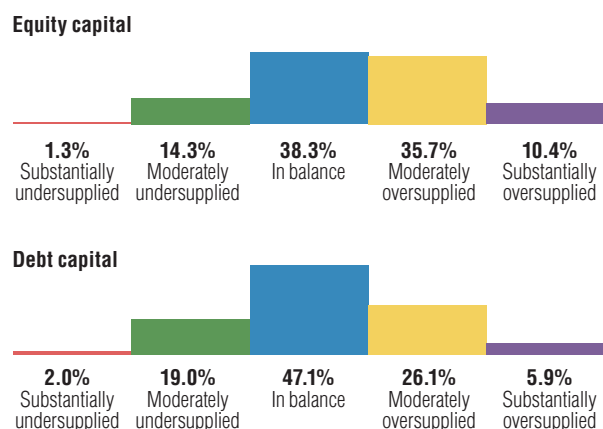
The easy availability of bank credit in Asia means that scope for nonbank lenders is limited. The one big exception to this is South Korea, where, for historical reasons, real estate is financed almost exclusively by insurance companies. China is the other outlier, with an ongoing bank credit squeeze that has led developers to invent innovative ways to get their hands on capital, from internet-based crowd funding to private bonds and various types of off-balance-sheet credit from the shadow banking sector.

For the same reason, local markets for alternative finance also remain limited. As one banker said, "Three or four years ago, we could do a lot more mezz [mezzanine] and pref [preferred equity] just because there was less liquidity." With the options for investing in straight equity deals squeezed so much by supply issues, many big players have looked at structured finance as another way to get into the markets. But pickings have proved thin. "We're not seeing it," said one banker. "You just can't do a lot of buying in that space. We've had quite a few groups—some of them sovereigns—that have come to us and said they wanted to form joint ventures specifically on mezz. But we can't find enough people [who] want to do it, and I don't think that's going to change unless the local bank liquidity pulls back."

That said, mezzanine still has its place in some situations, including China, where, according to one consultant, "We have a number of people who have traditionally been developers that at the moment are being bankers, providing mezzanine-level capital at [rates of] 20 percent to 30 percent. It's convertible, maximum 18 months, and worst case you end up with lots of units."

Still, both the bigger foreign banks and bigger domestic developers in China have little interest in debt. As one banker explained, "If we were investing 30 percent in a project and we had a preference return, we would overcollateralize from day one to protect ourselves, because that preference can only be a contract offshore, you can't be onshore. So we'd say, 'We're going to take 50 percent of the company from day one.' Now, the chairman says, 'What, you don't trust me?' And we say, 'It's not a trust issue, it's the bank, we have credit people.' But it's hard to get that done—with the big guys, you can't have that

Exhibit 2-18 Real Estate Capital Market Balance Prospects for 2016



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

discussion. They would say, 'Are you kidding me?' Some of them could buy the bank. So we move more to equity."

Lower down the food chain in China is where demand for mezzanine finance lies. Here, though, investors have to ask how much risk they want to assume. "I think there are structured deals to be done," said one investor, "but you have to dip down to a level of developer we're just not interested in." Many of the smaller, financially stretched developers carry so much debt on their balance sheets that adding more may not be feasible. In addition, the security provided by moving up the capital stack is somewhat illusory in China, where the mere fact that you have legally enforceable collateral may not mean much when trying to enforce against a locally powerful entity.

For the future, the mezzanine space promises to become more attractive should the banking sector tighten lending terms, possibly after a rise in U.S. interest rates. This is why one interviewee suggested Southeast Asia as the market with the most potential for structured deals, as countries such as Indonesia and Malaysia begin to experience slowing economies and a pullback in liquidity.

India Moves toward Equity Structures

The other market where structured finance has offered promise is India. On the one hand, local banks remain reluctant to lend to developers. On the other, foreign investors' experiences with equity investing when they first came to India after markets there opened in 2006 were negative. Over the last couple of years, therefore, foreign investors have adopted structures involving senior-secured lending (at 22 to 24 percent) or, more recently, preferred equity (at 21 to 23 percent).

Today, however, as the market becomes dominated by large foreign institutional investors, a shift away from debt in favor

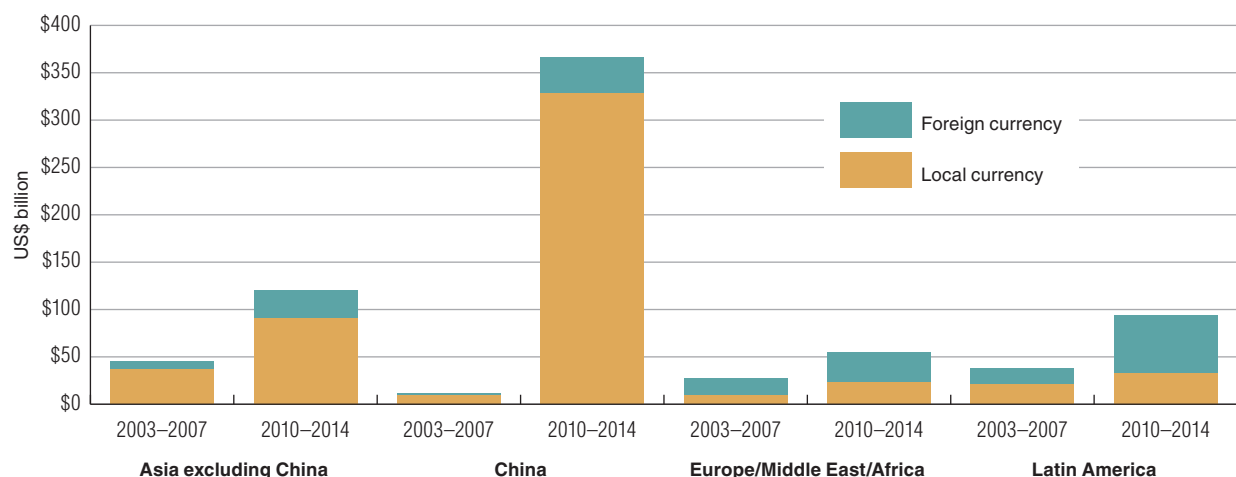
of equity structures has occurred. According to one locally based consultant, "Some 80 percent of foreign capital inflows to India have been all-equity buyouts from large players into large transactions, and most of these have been in the corporate real estate space where you're talking about large business parks and IT parks." This differs from 2006, when equity joint ventures with developers were the standard operational vehicles. Equity joint ventures with developers continue to be seen as high risk, especially on the residential side.

Still, even here the landscape is changing. Although some 80 percent of institutional capital going into Indian residential investments (almost all of it domestic) currently does so as structured debt (at internal rates of return [IRRs] of 18 percent to 19 percent), foreign investors are eyeing the sector, too. According to one interviewee, "One of the themes over the next year will be that foreign capital will be looking increasingly at coinvesting into joint ventures on the residential side with equity ownership structures—but only in the larger cities, with larger transactions, and with pedigreed developers."

Bond Sales Surprisingly Strong

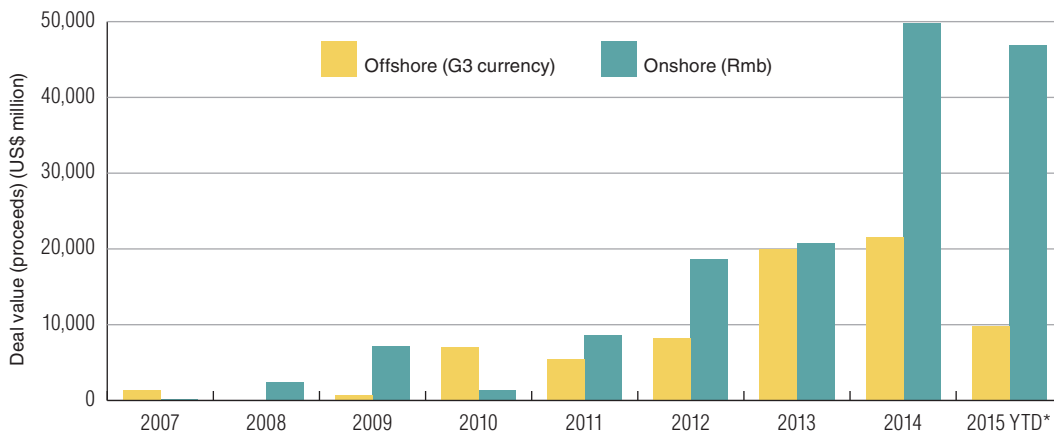
While Asian developers have traditionally relied on bank loans to finance some 75 to 80 percent of real estate construction, bonds now enjoy an increasingly prominent role. This is partly because banks are looking to diversify risk and partly because bonds are now more attractive to investors given the low yields offered elsewhere. Corporate bond issuance throughout all emerging markets has nearly doubled since 2009, according to the International Monetary Fund, reaching US\$900 billion in 2014. The vast majority of this increase has come from Chinese companies, and in particular from local property developers, that have turned to the bond markets as other financing options have dried up.

Exhibit 2-19 Bond Issuance by Region, Yearly Average



Source: International Monetary Fund.

Exhibit 2-20 China Real Estate Bond Volume



Source: Dealogic.

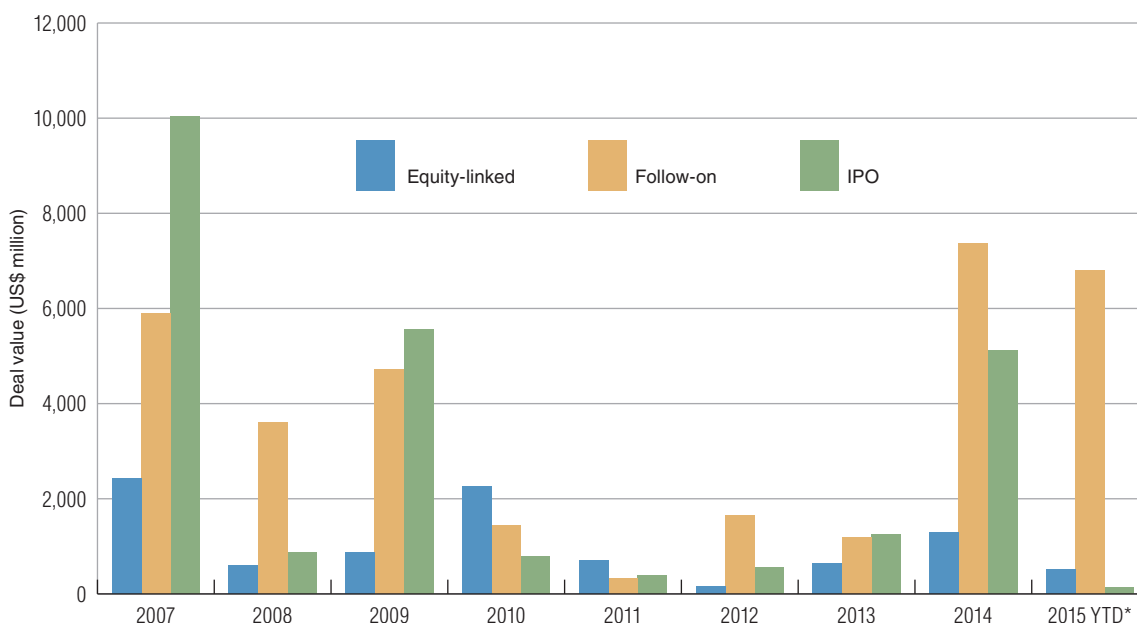
*As of October 9, 2015.

In the past, most Chinese developer bonds were issued in Hong Kong as foreign-currency debt. But after the Chinese government began easing restrictions in April 2014, both listed and unlisted developers began issuing bonds onshore, either privately or via public exchanges. This has proved a windfall for the large majority of capital-challenged local developers who are unable to issue foreign-currency bonds. Not only that, but high investor demand for domestic bonds means that local debt issuances are both larger and cheaper than the foreign equivalent. Prices are trading, in fact, at levels that probably fail to reflect the credit risk of the bonds.

As a result, Chinese domestic debt issuance has mushroomed over the last two years, filling the gap created by the retreat of the trust sector from real estate investing. Foreign-currency debt issues, meanwhile, have declined.

The main beneficiaries of this shift have been China's large and midsized developers, who have been using the cheaper funding to refinance existing debt. Smaller builders, meanwhile, have been shut out of the bond market and continue to struggle for financing of any kind. Perhaps counterintuitively, the recent crash in China's stock markets has served only to

Exhibit 2-21 China Real Estate Equity Capital Market Volume



Source: Dealogic.

*As of October 9, 2015.

boost demand for bonds as investors fleeing equity investments turn instead to the debt markets to place capital.

In a typical transaction completed in mid-2015, one prominent Chinese developer issued the equivalent of some US\$943 million in domestic five-year bonds at a yield of 4.2 percent. This represents some of the cheapest finance available in China today and compares to a yield of some 7.5 percent for U.S. dollar bonds obtained by the same company earlier in the year. It also compares to the roughly 11 percent returns demanded by the domestic trust sector and 6.5 percent required by banks. The fact that China's bond markets have thrived even against a backdrop of generally unhealthy developer balance sheets (including at least one well-publicized default) indicates ongoing appetite for yield among investors. With foreign-currency bond yields likely to rise if and when rates rise in the United States, the demand for domestic bonds is likely to remain strong going forward.

Chinese debt represents the lion's share of Asian issuance (some 63 percent in the first half of 2015), but bond financing is also strong elsewhere in the region. Some US\$2.1 billion in real estate-related bonds were issued in Singapore during the first half of 2015, well up on the US\$1.8 billion in the whole previous year.

On the equities side, developer share prices in China suffered big drops during the stock market crash in mid-2015. Still, shares had risen so much that even after the decline (i.e., in early November), the Shanghai Property Subindex was trading more than 50 percent higher year-on-year. And with Chinese developers having taken the opportunity to issue some US\$20 billion in new shares while the market was on the way up, balance sheets for most developers are better than they were at the end of 2014.

REIT Activity Slackens

The strong gains seen by Asia's major REIT markets—Japan, Australia, and Singapore—stalled in 2015 as investors tried to price in the timing of an anticipated hike in the U.S. base rate. Higher global interest rates are seen as a disincentive to REIT investors who are more likely to find alternative possibilities in the bond markets. They are also negative for REITs because they increase the cost of borrowing required to fund new purchases. In addition, if REIT prices fall in the United States, this tends to have negative repercussions for Asian REITs because many of their shareholders are funds that must maintain average weighting of stocks by value.

Japan

Although Japanese REIT (J-REIT) prices in the fourth quarter of 2015 are roughly similar to year-ago levels, they remain up 66 percent from October 2012, when Prime Minister Shinzō

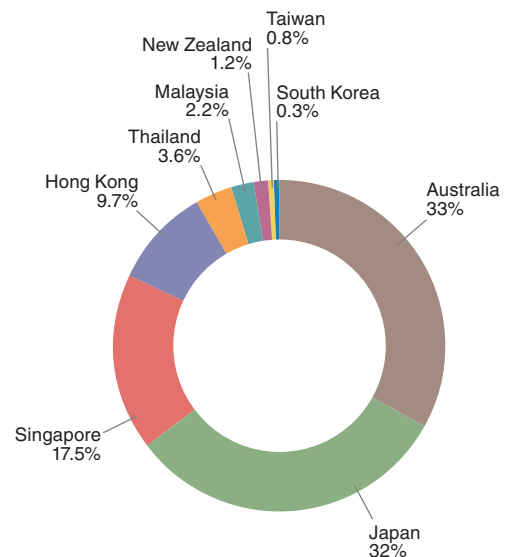
Exhibit 2-22 Major REIT Listings in Asia in 2014

Pricing date	Issuer	Value (US\$ million)
Jan. 29	Hulic Reit (Japan)	\$683
Sept. 18	Impact Growth Real Estate Investment Trust (Thailand)	\$488
May 28	Invesco Office J-REIT (Japan)	\$436
Apr. 15	Nippon REIT Investment (Japan)	\$375
June 23	Frasers Hospitality Trust (Singapore)	\$320
Jan. 17	OUE Commercial REIT (Singapore)	\$284
Aug. 4	IREIT Global* (Singapore)	\$118

Source: Dealogic.

*Excludes strategic investor's stake.

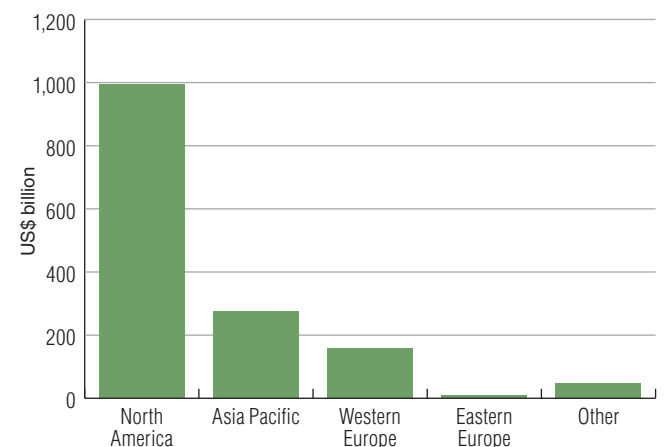
Exhibit 2-23 Share of Asia Pacific REIT Market Cap, by Country



Source: Asia Pacific Real Estate Association.

Note: Market cap as of November 2015.

Exhibit 2-24 Global REIT Market Cap

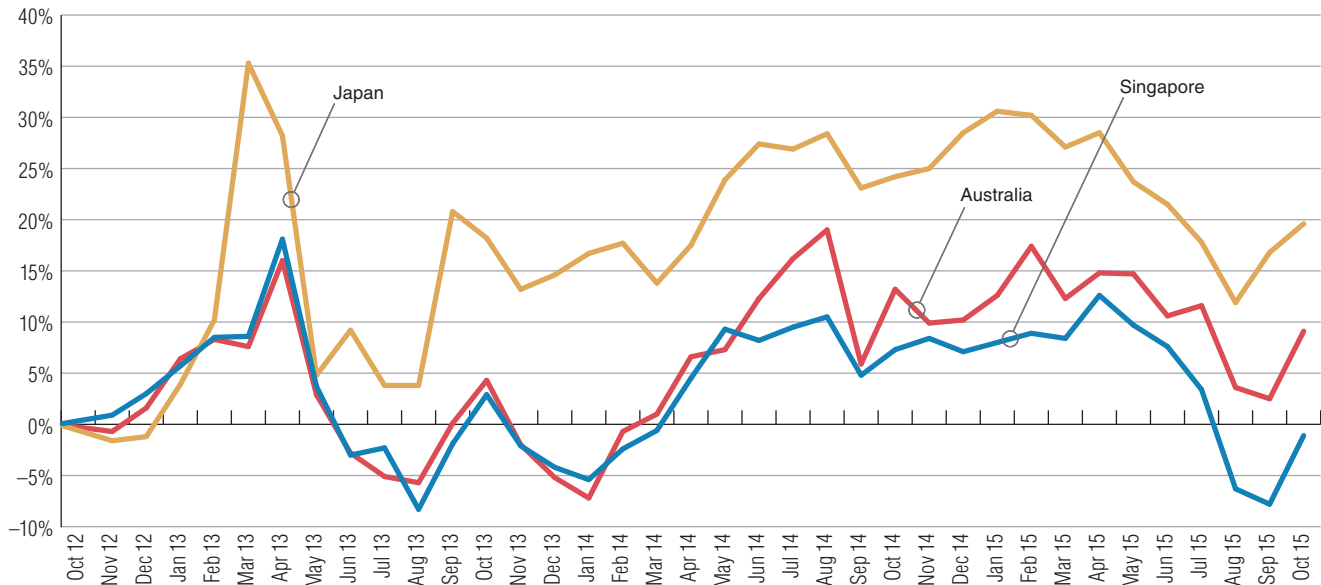


Source: Asia Pacific Real Estate Association.

Note: Market cap as of June 16, 2015.

Exhibit 2-25 Percentage Change in Asia Pacific REIT Markets

Change as a percentage of October 2012 values



Source: Asia Pacific Real Estate Association.

Abe ushered in the era of Abenomics with a mandate, among other things, for the Japanese government to buy J-REIT shares. At the same time, however, they are now down around 15 percent from the January 2015 peak.

As their share prices rose and they collected more cash from follow-on offerings, J-REITs became the biggest purchasers of real estate in Tokyo, representing over 30 percent of all transactions in the first half of 2015, according to Deutsche Asset & Wealth Management. Follow-on offerings raised a total of US\$4.3 billion in the first eight months of the year, according to data provider Dealogic, but their buying spree has tapered during the second half. One reason for this is that cap rates have compressed in Tokyo to levels where even J-REITs are reluctant to buy, indicating the market may be reaching a threshold.

According to one Tokyo-based fund manager, “J-REITs have slowed down quite a bit right now. A lot of them have not had the best experience getting follow-on [offerings], or are near capacity in terms of their debt ratios. So a lot of the larger ones are on the sidelines.” As a result, in the second half of the year, their role as dominant buyers has been assumed by heavyweight foreign institutions and private equity funds.

Average J-REIT yields were about 3.5 percent as of fall 2015, which is much lower than in other regional markets, but still a healthy 300 basis points or so over the Japanese ten-year government bond.

Singapore

The REIT sector in Singapore also saw a significant sell-off during the summer, and although it has rebounded coming into the end of the year, it still offers an attractive 6 to 7 percent yield.

The high density of REITs now based in Singapore means that relatively few suitable assets are available to buy there. This has had an obvious impact on domestic REIT activity. In addition, the rising base rate in the city-state has increased REITs' financing costs—a trend that can only continue if the Singapore dollar weakens more. Another issue is that, although cap rates have not moved much, rents in “REITed” space are generally soft.

As a result, most of the buying action has moved to other markets. According to a local REIT manager, “REITs have taken the view that offshore assets can be more competitive, just as sustainable in earnings, and for the most part, whatever risk there is associated with the repatriation, the currency, interest rates, or what have you can all be boxed in.”

Australia in particular has seen substantial buying activity from Singaporean REITs in 2015, with one especially large deal in the logistics sector. Singaporean REITs have also bought assets in Japan, China, and South Korea during the year.

Australia

Share prices for Australian REITs (A-REITs) had risen some 15 percent year-on-year by the fourth quarter of 2015. Results have been strong and asset values have risen significantly

Exhibit 2-26 Asia Pacific REIT Yields

Countries	Average dividend yield	Number of listed REITs	Listed REIT market cap
Australia	4.81%	55	\$88,377,068,218
Hong Kong	4.26%	11	\$25,796,413,248
Japan	3.14%	51	\$84,717,235,584
Malaysia	6.29%	16	\$5,793,524,328
Singapore	6.35%	38	\$46,639,457,696
Taiwan	3.07%	5	\$2,135,666,112

Source: Asia Pacific Real Estate Association.

Note: Yields as of November 2015.

as cap-rate compression has reerated the market. LTV ratios are much lower than during the global financial crisis. Yields are about 5.5 percent but are expected to grow at a healthy 4 percent annually.

A-REITs have benefited from falling interest rates and the overall quest for yield—given the good (and widening) risk-free spread, returns still seem attractive. However, with cap rates continuing to move down, identifying accretive acquisitions remains difficult.

New REIT Markets: China, the Philippines, India, and Indonesia

The more interesting developments in the Asian REIT industry this year center on continuing efforts to introduce REIT infrastructure in various new markets around the region. In particular, China saw the emergence of a handful of “prototype REITs” at the end of 2014 and the beginning of 2015. These amount to a trial balloon for real estate securitizations. However, there is so far no sign of a regulatory framework in which a wider REIT industry might evolve in China and, according to one interviewee, “nobody has a date within the next two years for a REIT framework to be legislated.” In particular, there is no indication that the government is set to introduce or even discuss the issue of tax neutrality, without which REITs will be unable to offer a competitive yield.

On top of that, so far China’s prototype REITs do not even own their own properties—instead, they have access only to income streams generated by rents within a given portfolio of assets. As a result, the China prototype REITs are purely yield-driven plays, which may prove a tough sell in a market where cap rates have been compressed to “ridiculous” levels and investors are more focused on capital gains than on dividends or defensive investments anyway.

The Philippines, meanwhile, is more advanced in its pursuit of a finalized REIT regulatory structure, having introduced

a code some six years ago. The stumbling block, however, remains the vexed issue of tax neutrality, which the current government has been reluctant to introduce. With an election coming up, one Philippines-based investor said the next administration may be more amenable to changing the implementing guidelines so as to reduce taxes on initial transfers of assets into funds, and abolish the requirement to sell two-thirds of assets within three years. “If [those are] modified,” he said, “we’re going to have a vehicle that will interest a lot of people.”

India is looking to establish a REIT industry, too. Many of the current crop of foreign investors now active in India are eyeing REITs as a potential exit strategy for their investments. The government introduced a regulatory framework in 2014 outlining rules for REIT structuring, but the arguments again revolve around tax neutrality. This is an especially complex issue in India because, apart from anything, there are currently three separate taxes that would apply to REIT structures. Although one of these seems now to have been ended, there is so far no agreement on the others.

A resolution may take years to hammer out. According to an India-based interviewee, the government is “nowhere close” to resolving the issue. There remain “a lot of gray areas,” he said, and India’s slow-moving political culture may create gridlock going forward. Although an alternative option exists for investors to list Indian assets in Singaporean-based REITs instead, this would be inefficient in a number of ways. “Will the India [REIT] story happen in the next 12 months?” he asked. “Absolutely not—in fact, I’d be pleasantly surprised if this government regime, which still has a good three-and-a-half years to go, is able to get the first Indian REIT off the ground within its five-year tenure.”

Finally, Indonesia is another market where tax issues have stymied the development of a local REIT industry, despite the introduction of an appropriate regulatory framework several years ago. However, in October 2015, authorities announced an easing of tax rules that may now make REITs domiciled in Indonesia more attractive. It remains to be seen how these changes will be implemented in practice, as the specifics of the change have yet to be disclosed. Notably, however, one large Singapore-based REIT that invests in Indonesia has already announced its intention to relocate to the country.

Markets and Sectors to Watch

“The definite focus now is on **completed assets** with cash flow in core locations.”

If the main themes from this year’s research reflect both an abundance of capital in the core space as well as a flight to safety in the region’s most developed and liquid markets, it comes as no surprise that the top four cities in this year’s survey are in markets that best reflect those qualities—Japan and Australia.

Tokyo’s top ranking in 2016 completes a hat trick of wins for the city over the last three years, as the government’s ongoing easing policies continue to boost asset prices. Japan’s status as an investor favorite is reinforced by Osaka’s continuing popularity, which is a repeat of last year’s strong showing. Sydney’s and Melbourne’s second- and third-place positions,

meanwhile, underscore investors’ enduring quest for asset quality and yield, with both foreign and domestic institutions fighting to corner an ever-shrinking pool of Australian assets.

Other top trends to emerge from the *Emerging Trends* survey include the following:

- Investors continue to be skittish about assets in China, with concern centered on an array of issues ranging from a soft economy, a depreciating currency, oversupply, high values, and compressed cap rates. Shanghai is a shelter in the storm, however—its middling performance in our survey reflects its status as China’s only true gateway city

Exhibit 3-1 City Investment Prospects, 2016

	generally poor	fair	generally good
1 Tokyo			3.66
2 Sydney			3.52
3 Melbourne			3.43
4 Osaka			3.39
5 Ho Chi Minh City			3.21
6 Jakarta			3.20
7 Seoul			3.18
8 Manila			3.17
9 Shanghai			3.15
10 Auckland			3.14
11 Singapore			3.10
12 Bangalore			3.06
13 Mumbai			3.06
14 Beijing			3.02
15 Hong Kong			2.99
16 New Delhi			2.98
17 Taipei			2.92
18 Shenzhen			2.89
19 Bangkok			2.86
20 Guangzhou			2.84
21 Kuala Lumpur			2.76
22 China—secondary cities			2.54

Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

Exhibit 3-2 City Development Prospects, 2016

	generally poor	fair	generally good
1 Tokyo			3.49
2 Sydney			3.31
3 Melbourne			3.22
4 Ho Chi Minh City			3.22
5 Osaka			3.21
6 Jakarta			3.16
7 Manila			3.15
8 Seoul			3.10
9 Singapore			3.05
10 Shanghai			3.04
11 New Delhi			3.00
12 Auckland			2.99
13 Mumbai			2.99
14 Hong Kong			2.98
15 Bangalore			2.97
16 Bangkok			2.95
17 Taipei			2.91
18 Beijing			2.89
19 Guangzhou			2.79
20 Shenzhen			2.74
21 Kuala Lumpur			2.74
22 China—secondary cities			2.56

Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey*.

where prime assets will always be in demand.

- The industrial/logistics sector continues to be highly favored on the basis of its better-than-average cap rates tied with what is likely to be long-term structural undersupply.
- Emerging markets have enduring appeal, although in practice little foreign capital is finding its way there—investors drawn by higher yields and long-term growth potential remain wary of high economic, political, and business risk. However, the rehabilitation of Vietnam as an investment destination following several years of economic misadventure and overregulation is noteworthy.

Leading buy/hold/sell ratings for the various asset classes were as follows:

- Industrial/logistics—buy Jakarta, sell Auckland;
- Residential—buy Tokyo, sell Taipei;
- Office—buy Jakarta, sell Guangzhou;
- Retail—buy Tokyo, sell Guangzhou; and
- Hotel—buy Tokyo, sell Beijing.

Top Investment Cities

Tokyo (first in investment, first in development). At the moment, Tokyo ticks all the boxes for investors. Its status as arguably the number-one gateway city in Asia, with the greatest market depth and liquidity, qualifies it as something of a defensive play (although many argue the contrary given chronic weakness in the Japanese economy). In addition, ongoing quantitative easing policies have been the catalyst for three years of unbridled asset-price growth and cap-rate compression, delivering excellent cash-on-cash yields given ultra-low local interest rates and government bond yields.

Exhibit 3-3 Historical Investment Prospect Rankings

	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
Tokyo	1	1	1	13	16	12	7	1	3	3
Sydney	2	4	5	4	3	6	6	14	15	16
Melbourne	3	5	13	10	7	9	9	11	17	6
Osaka	4	3	9	22	21	19	18	15	4	1
Ho Chi Minh City	5	13	19	18	10	11	13	13	8	12
Jakarta	6	2	3	1	11	14	17	20	20	19
Seoul	7	7	15	14	19	16	4	6	7	13
Manila	8	8	4	12	18	20	20	19	19	18
Shanghai	9	6	2	2	2	2	1	5	1	2
Auckland	10	15	17	17	20	18	16	17	14	—
Singapore	11	9	7	3	1	1	5	2	2	4
Bangalore	12	17	20	19	9	10	14	4	12	10
Mumbai	13	11	22	20	15	3	8	7	10	17
Beijing	14	10	8	7	5	7	3	12	6	9
Hong Kong	15	21	18	11	13	4	2	3	5	11
New Delhi	16	14	21	21	12	5	10	9	13	14
Taipei	17	18	16	9	8	13	11	8	16	5
Shenzhen	18	19	10	16	—	—	—	—	—	—
Bangkok	19	16	11	6	14	17	19	18	18	8
Guangzhou	20	20	6	15	6	8	12	16	9	7
Kuala Lumpur	21	12	14	5	17	15	15	10	11	15
China—secondary cities	22	22	12	8	—	—	—	—	—	—

Source: *Emerging Trends in Real Estate Asia Pacific 2007–2016 surveys*.
Note: — = no data.

On top of that, local banks' willingness to lever purchases as high as 90 percent at rates of only 200 to 250 basis points (bps) has been a siren call for investors looking to create financially engineered investments—a play that has so far generated stellar returns.

The fear now is that momentum may slow. According to one investor, "A lot of people sense the market's prob-

ably peaking," even as a torrent of new capital in the form of Japanese pension funds is about to arrive.

One reason for this concern is that cap rates may have reached a point where further compression is impossible. That certainly seems to be the consensus of many domestic investors who make up the majority of buyers. As one veteran Tokyo-based fund manager said, "I just don't see residential ever becoming a 3 to 3.5 [percent] cap-rate market here—investors have never had to pay that in this market, and domestic institutions just aren't going to do it."

That becomes a problem because so many current deals have underwritten further cap-rate compression to justify projected returns. The question then becomes: can government policies finally gain traction and deliver promised economic growth, thereby boosting earnings and rents? If not, according to one investor, refinancing risk looms in



2018 as many high-loan-to-value (LTV) loans come due. “What happens if this place doesn’t inflate, if Abenomics is a failure, and we’re stuck with this deflationary [environment]?” he asked. “It’s going to affect the real estate market very negatively; and then a year or two later, you’ve got a long coming due—it could be a bit dicey around then.”

Sydney (second in investment, second in development). While the Japanese market is a magnet for investors of all types—from institutional to opportunistic—real estate investment in Australia is driven primarily by institutions looking for core office properties. The shortage of that type of asset, combined with an influx of new institutional buyers, has driven cap rates for the best Sydney buildings down to levels approaching 5 percent—or about the same as their lowest levels in pre-global financial crisis days. That said, the apparently low yields are distorted by rent incentives that have risen to around 35 percent—a level that seems unlikely to decline significantly for the foreseeable future.

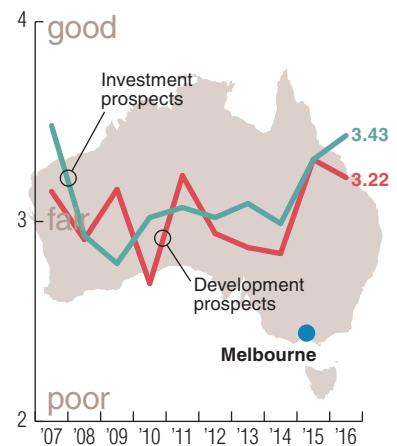
The high level of incentives, together with strong buyer demand and still-wide spreads to the risk-free rate, means that cap rates still have room to run. The rapid depreciation of the Australian dollar over the last year has also helped. According to one investor, “People who recently may have thought that prices have been too high are now think-

ing it’s quite good pricing for the U.S. dollar—and that’s probably giving that added bonus.” Another factor driving up prices in Sydney is the fact that it is now a magnet for international funds drawn by relatively high yields, especially when compared with other cities in the region. Foreign buyers will generally pay higher prices than the locals, and with several Asian sovereign wealth funds now actively looking for properties to buy, pressure on yields is expected to continue.

Real estate in Sydney is also benefiting from structural changes to the Australian economy as it adjusts from a commodities-driven to a service sector-driven model. In the past several years, office demand from the service sector has been weak. Today, however, increasing numbers of new white-collar jobs are being created, soaking up some of the large amounts of new stock that continue to arrive from new developments such as Barangaroo.

Sydney has also been a recent source of office-to-residential conversion or redevelopment deals. Although strong residential demand continues—Sydney housing prices are up almost 50 percent over the last three years—these opportunities may decline as authorities tighten planning rules in the central business district (CBD).

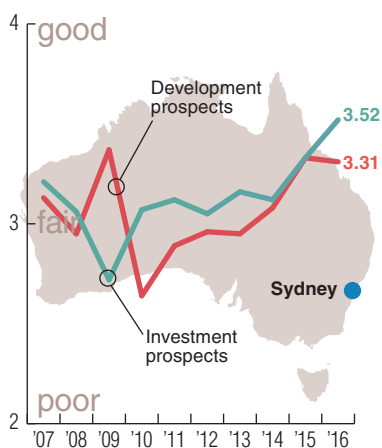
Melbourne (third in investment, third in development). Melbourne attracts investors for much the same reason as Sydney—a service sector-based economy, relatively high cap rates, and the advantages of a depreciated local currency. At the same time, however, and even after strong double-digit price increases in 2015, Melbourne’s capital values remain significantly lower than Sydney’s, mostly as a result of a much larger supply of land to expand the CBD. Rental incentives stood at a high 32 percent in the middle of 2015, while cap rates for prime CBD property are currently around 5.5 percent.



Over the last few years, Melbourne has had to contend with an even bigger supply pipeline than Sydney, leaving it with relatively high vacancies of around 10 percent, according to CBRE. However, absorption in the CBD continues to be strong, both from newly arrived businesses and those moving to the city center from the suburbs. According to one locally based analyst, “Our house view is that vacancy rates will pick up again, but probably not to an extent that gives a huge degree of concern—towards the end of the decade, we think Melbourne will be in good shape again. On the supply side, there are a few buildings completing in 2016, but again nothing that will cause a lot of heartache.”

Like Sydney, Melbourne has enjoyed a thriving office-to-residential conversion/redevelopment story that is beginning to slow as city planners step in to preserve the dwindling supply of office space in the CBD. That has meant that Asian—and especially Chinese—residential developers are increasingly active in areas ten to 12 miles (16 to 19 km) from the city center.

Osaka (fourth in investment, fifth in development). Osaka continues to benefit from Tokyo spillover demand as investors migrate from the capital to secondary cities where competition (especially from J-REITs) is not as strong. Like those in other Japanese secondary markets, Osaka’s yields are

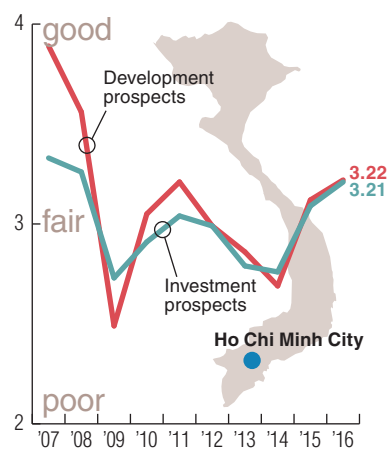




significantly higher than Tokyo's. The residential sector is a particular favorite, currently trading at cap rates anywhere between 4.5 and 5.25 percent. Commercial assets trade slightly lower but have been slower to compress, meaning that "deals that could have potentially more cap-rate compression are now outside Tokyo."

According to one investor, "From all the data we're seeing now, they're actually getting better [residential] rent growth in Osaka than in Tokyo. That's supply and demand, given net migration into the city. I think Osaka and other major cities like Fukuoka, Sapporo, and Nagoya are still very strong residential markets, with good rent potential. We're certainly seeing occupancy levels increase—I think it's a good play."

Like Tokyo, Osaka registered strong office capital value growth in 2015, with prices rising 24 percent year-on-year as of the middle of the year. Despite this, vacancies have continued to trend down, reaching 5.9 percent, according to Jones Lang LaSalle. This marks the end of a long period of oversupply that plagued the city for several years. With strong demand continuing and little new supply in the pipeline, market fundamentals suggest that capital values will continue to grow. Several interviewees also warned, however, that Osaka and other secondary cities are usually the first to turn when the cycle peaks.



Ho Chi Minh City (fifth in investment, fourth in development).

The speed with which sentiment can change in Asian markets is illustrated by Ho Chi Minh City's meteoric rise up the rankings, from 19th place as recently as 2014 to fifth place today. Driven by an economic rescue program that has intermediated billions of dollars in bad debt and recapitalized the banking sector, authorities have now stabilized the local currency, tamed inflation, and revived lending to the real estate sector by local banks. The economy is currently growing at close to 7 percent annually, the fastest rate since 2008.

The speed of the rebound has been remarkable, with residential property transactions in the first six months of 2015 doubling year-on-year and developers halving the huge stock inventory carried since the downturn began in 2013.

Foreign real estate investment has also been boosted by regulatory reforms introduced in July 2015 that should improve market access for foreigners. This could create significant new volumes of homebuyers as some of the millions of Vietnamese living abroad return to buy property, especially at the high end of the market. Anecdotal reports suggest that sales to foreigners in the second half of the year have been strong.

While the most common way for foreign investors to participate in the

Vietnamese market is via residential projects, reforms also target the commercial sector, with foreign businesses now allowed to buy offices and factories for business purposes, opening the door to full ownership of production bases by foreign investors. Although one investor warned that "in the commercial sector there's a lot more supply, so it's going to take a bit longer to come back," this change is meaningful given that foreign direct investment (FDI) in Vietnam is rising fast (up 30.4 percent in the first eight months of 2015) as factory owners opt increasingly to build new factories in Southeast Asia rather than in China.

There is probably more upside to come in Vietnam, but with most of the rebound now already reflected in prices, some foreign investors are kicking themselves for not acting earlier. According to one, "They've dealt with a lot of their problems, the banks are flush, and now foreign investment wants to move in. I don't think we've completely missed it, but we wanted to be there two or three years ago. I could get my investors to be contrarian in India, China, and some of the other Southeast Asian markets, but they just refused to be contrarian up in Vietnam—so we missed a nice piece of the uptake there."

Jakarta (sixth in investment, sixth in development).

Indonesia placed prominently in the *Emerging Trends* survey for the last three years, but dropped several places in 2016 as sentiment fades. While the same overarching growth expectations remain in place, economic uncertainty across the whole of Southeast Asia has risen this year, partly as a result of concerns over capital flight as the United States prepares (perhaps) to hike interest rates, partly due to an overall downturn in global commodity markets, to which the Indonesian economy is to some extent reliant, and partly because of concerns regarding oversupply in Jakarta's commercial property sectors.



According to one Singapore-based fund manager, “I’m going to stay away from anything in emerging Southeast Asia because there’s a multiplicity of risk you just cannot underwrite adequately, whether it is getting really fringe in Yangon, or Jakarta, or Kuala Lumpur.” That said, Jakarta remains a focus for many Southeast Asian investor groups, and in particular for institutions and large integrated developers operating out of Singapore and Hong Kong. It remains a market for long-term players rather than private equity funds concerned more with short-term internal rates of return (IRRs).

In terms of fundamentals, the big issue on the office side is that thinner demand for space since the second half of 2014 has coincided with a big pipeline of new supply. As one investor said, “There are tower cranes everywhere and there’s going to be a massive supply glut. Combined with the domestic economy slowing down, there’s probably going to be a tenant’s market for a while yet.” Oversupply will affect some parts of the market more than others, however. In particular, the amount of office space in international-grade buildings with good access will remain in short supply, meaning that demand and pricing for that asset type will probably continue to be high.

As usual, risk in Jakarta remains relatively high and is headlined this year by potential currency depreciation caused

by capital flight. This has affected all developers with exposure to U.S. dollar debt or materials, potentially creating distress scenarios.

Seoul (seventh in investment, eighth in development). Over the last couple of years, South Korea has enjoyed a renaissance in foreign investor interest, with many investment funds drawn by Seoul’s status as a gateway city offering reasonably attractive yields (at around 4.4 percent in the office sector) together with a positive spread over the cost of debt. At the same time, with South Korea’s big institutional investors competing to buy stabilized assets, finding stock can be a problem. Some investors are therefore looking at development strategies with a build-to-core focus.

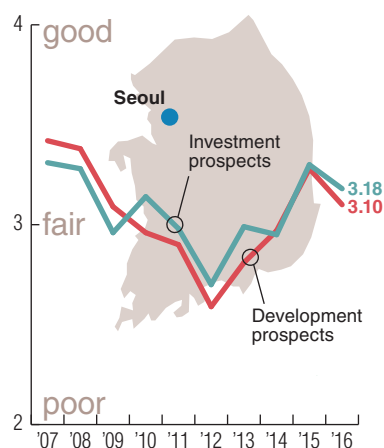
With little new upcoming supply and capital value increases of around 8 percent year-on-year as of mid-2015, most interviewees remained positive about prospects in Seoul, with several deals expected to close in the second half of the year.

Otherwise, South Korea has proved surprisingly popular with opportunistic investors. According to one fund manager, “The capital here tends to be core or core-plus oriented, so in theory there should be a vacuum for the more risk-type deals. But it’s hard to be thematic—it’s really about what you can find or what can you originate. You don’t need to place a lot of money in Korea

to get the diversification benefit that we look for.” In particular, several interviewees mentioned an interest in South Korean logistics plays, identifying a lack of modern facilities, decent yields, and good long-term demand for new space.

Manila (eighth in investment, seventh in development). The Philippines remains an attractive destination, with a thriving outsourcing industry and a strong flow of foreign currency remittances from its army of workers living abroad. Capital values for commercial property in Manila are increasing at a double-digit pace and rents also are showing good growth. Several interviewees identified the city as having the best investment prospects among all emerging economies, but noted the difficulty of getting money into the market. As one said, “I would invest in the Philippines if I had the opportunity, even above Vietnam, but barriers to entry in the Philippines are much higher.”

This is mainly because there is little demand for the type of capital that foreign funds have to offer. Not only are local banks open to providing liquidity to developers for construction purposes, they are also willing to refinance quickly. According to one local developer, “When we do a project and it’s strictly construction, we borrow 60 to 70 percent LTV. But the moment you’re fully leased and you’ve got your occupancy permit, they then go to enterprise value, so you usually can get double or triple



what you got in construction funding. There's then no interest in selling to a fund because you're cash flow positive—so it's really buy-and-hold for the guys who have been in the construction business for some time.”

Meanwhile, demand for new commercial product remains strong. The business process outsourcing (BPO) story continues to gain traction as foreign multinationals migrate to Manila to establish call centers or back offices, with focus falling increasingly in Fort Bonifacio as a second CBD. Retail also is booming on the back of remissions to the Philippines from abroad. Oversupply issues mean residential—especially at the high end—is the one area currently having problems.

Shanghai (ninth in investment, tenth in development). China may have received a fair amount of negative sentiment this year, but Shanghai has remained at least fairly popular among investors. One reason is that, unlike secondary and tertiary cities, Shanghai is not carrying large quantities of unsold inventory. In any event, pricing and transactions have remained buoyant in both the residential and commercial sectors.

Shanghai's status as China's top business center is its big advantage. As one investor explained, “It has a history as an international city, and as an international investor I feel I can go to Shanghai and have substantially all the types of support I would get in a developed market. I can also acquire assets without a joint venture partner, or giving control to someone local, and there's less government interference. So there's a lot of transparency within that market over and above what you find elsewhere in China.”

At the same time, the Shanghai residential market remains “highly competitive and lacking in opportunity” compared with other cities that benefit from Shanghai's growth but are not so



crowded, such as nearby areas in the Yangtze River Delta. That is especially the case in 2015, with the city's home prices rising 8.3 percent year-on-year in September despite a stock market crash and the generally soft domestic economy. Instead, the trend for investors this year has been to return to the staple diet of core office assets. This is somewhat surprising given an upcoming pipeline with “several years of fairly significant oversupply.” In addition to that, cap rates may be slightly wider this year, but at around 4.5 to 5 percent offer what are often perceived to be poor risk-adjusted returns.

One reason for core's resurgent popularity is that local investors are increasingly active as focus shifts from the stock market. Another is that investors now see Shanghai increasingly as a gateway city where pricing will endure through market cycles. It therefore qualifies as a defensive play that is attracting core and core-plus funds. At the same time, it offers potential upside in that if Shanghai follows anything like the growth trajectory it has seen over the last 20 years, capital values and/or cap rates will continue to move in favorable directions.

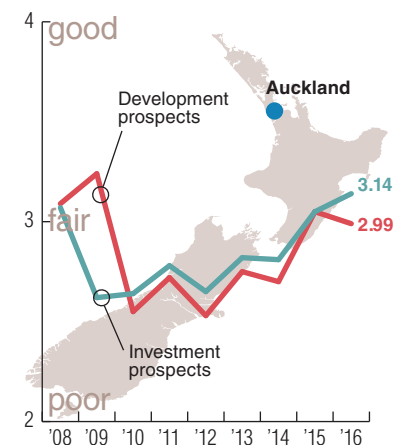
Still, not everyone is convinced that core office in Shanghai is a good buy. According to one investor, “My concern is that China's just so good at putting in infrastructure and making inaccessible locations accessible, secure, and

tied up to all the utilities, that even the bad office buildings now are acceptable at a price. So we're seeing in some of our projects that we have some really inferior competition, and we'll get occupancy versus them, but we can't push rate. We'll do okay because our product's better, but we haven't been able to get the rents we wanted. So we'll have to wait another turn on these things to do what we need to do.”

Auckland (tenth in investment, 12th in development). Until recently, New Zealand was regarded as something of a backwater among Asian real estate markets. But Auckland's star has risen since Asian investors began arriving in significant numbers in 2014. The influx has since continued, with a number of global institutional players joining others from Singapore (in particular GIC) and China to buy prime office assets that offer impressive yields of around 7 percent. Double-digit capital value growth has helped draw investors, as have New Zealand's low taxes.

With vacancy rates of 5 percent continuing to trend down and only moderate amounts of new stock due to arrive over the next couple of years, both cap rates and prices are expected to tighten. A shortage of assets at the top end of the market means that cap rates for B-grade assets also are expected to compress.

On the residential side, the market has been even hotter. The rapid rise in



housing prices led the government to increase LTV ratios for home purchases in 2013, but this did little to keep the lid on the market. Prices in Auckland jumped 26 percent year-on-year as of mid-2015, according to the Real Estate Institute of New Zealand, and are now more than 50 percent higher than eight years ago. With capital flows also continuing to rise, authorities again increased mortgage deposit rates (for Auckland only) to a minimum of 30 percent in the middle of 2015.

Singapore (11th in investment, ninth in development). Markets in Singapore have struggled to gain traction in 2015 after a fairly good year in 2014, when rents rose some 14 to 15 percent. A large volume of impending office supply, combined with weak leasing demand from the finance sector, suppressed rents as much as 5.5 percent quarter-on-quarter in the third quarter of the year. According to one interviewee, “Some of the new projects, especially the mega-large ones in the city center, will be complete in a couple of years. So in terms of the next two or three years, I don’t think people are seeing more upside on rent—occupancy will be great if we can maintain it where it is today.”

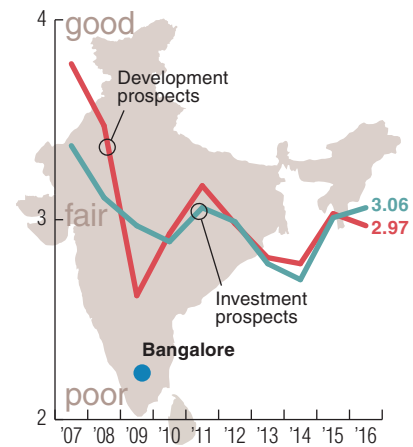
In addition, many businesses are having problems realizing expansion plans due to a tight labor market and ongoing government restrictions on hiring foreign staff. Yields have expanded somewhat, therefore, although with little pressure

on owners to sell, capital prices have so far held up quite well, leaving yields at around 3.8 percent.

Still, Singapore is always a market where institutions are looking to buy, and a number of purchases are expected to complete before the end of 2015, mainly from investment funds looking to liquidate assets. According to one fund manager, “There’s some pent-up investment demand, and there are some willing sellers who have for whatever reason properties they would like to sell, funds that are beyond where they should be with their investment period. So there will probably be a certain amount of competition for those assets and they’ll get reasonable prices—but it’s not a market that looks like it’s going to explode on the upside.”

The residential market, meanwhile, is “in a terrible state,” largely as a result of government measures introduced in 2013 to stem rapidly increasing home prices. These have particularly affected the top end of the market. However, some interviewees are now calling for a bottom in residential pricing in 2016, either because the government decides to change policy or because pent-up demand will be seen coming back into the market. In the meantime, negative sentiment in the residential sector is having an impact on sentiment elsewhere. As one investor commented, “It affects all the ‘aunties and uncles’ who would otherwise have been buying second and third units and then spilling over into the retail strata market, the office and the industrial strata market—this year, that’s definitely gone cold.”

Bangalore (12th in investment, 15th in development). With take-up of some 108 million square feet (10 million sq m) of new space expected in 2015, Bangalore is today the “real estate capital of India,” according to one interviewee, “accounting for almost as much office uptake as Delhi and Mumbai combined.” It continues to see substantial activity by large foreign private

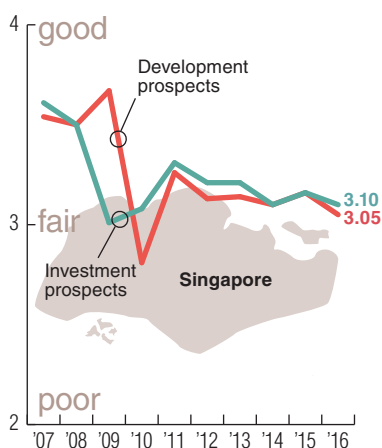


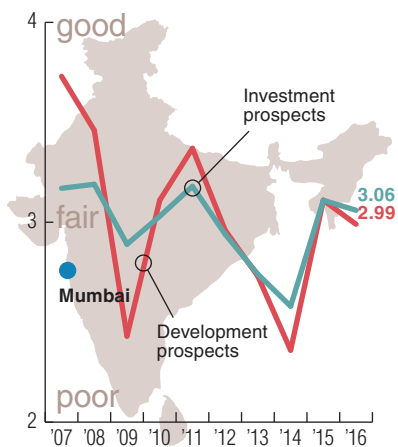
equity firms involved in joint ventures to develop office space for offshoring and BPO use.

In addition, Bangalore is increasingly becoming the technology capital of India, as venture capital firms bring in startups to take advantage of the city’s large numbers of qualified engineering and support staff. According to one locally based consultant, “What we’ve seen for the first time during the last 12 months is that firms that were originally based out of Delhi, Pune, or Mumbai, but grew to a \$600 [million] to \$700 million valuation and were in the race for a \$1 billion valuation, have been pushed by their venture capital backers to relocate to Bangalore because that’s where you find the critical mass to be able to ramp up your business.”

The huge amount of upcoming supply (some 18 million square feet [1.7 million sq m], according to CBRE) due to arrive over the next two years has generated little concern about oversupply because absorption rates continue to be very high. Current vacancy rates of only 6 percent are therefore not expected to increase, while both rents and capital values should continue to rise.

Mumbai (13th in investment, 13th in development). While fundamentals in Mumbai reflect currently high levels of supply, in reality the situation varies significantly from area to area within the city. So although on paper falling office





rents and vacancies of around 20 percent suggest a downturn, much of that excess capacity is focused on particular areas and even particular buildings. More popular downtown areas favored by either financial or IT sector companies remain tight in terms of occupancy and pricing. As a result, “you’ve seen some large transactions continue to happen in the downtown areas,” with assets continuing to be sought after by foreign institutional money.

As one interviewee summed it up, “Mumbai is on a recovery path on the commercial real estate side, and downtown is on stable ground. Other parts of the city where you see oversupply will take another two or three years to stabilize because the developer community is so strapped for capital.”

The residential sector, meanwhile, is a similar story. Fundamentals are strong downtown but weak elsewhere, with considerable pockets of oversupply. According to one interviewee, “There is clear pain in the developer community, and with a reasonable amount of oversupply in the suburbs, if someone is willing to put money on the table there is enough pain for people to be able to transact good-quality deals.” A recent slowdown of new project approvals, however, is helping relieve the oversupply situation.

Beijing (14th in investment, 18th in development). In many ways, Beijing’s



property market is similar to Shanghai’s. The city is therefore seen as something of a defensive play in a national market that has currently lost favor with many foreign investors. As in Shanghai, Beijing’s office market has remained buoyant, while the residential sector has shown ongoing strength even as other markets across the country continue to struggle.

In fact, in some ways, Beijing’s office sector might be considered more appealing than Shanghai’s given that vacancies of around 5 percent remain tight, with little in the way of upcoming supply. In addition, office rents and capital values have been fairly stagnant over the last five years, even as increasing demand for space from state enterprises means that vacancies have steadily declined.

At the same time, however, most foreign investors would prefer to invest in Shanghai given the choice. According to one, “There’s just not enough activity in Beijing, because most buildings are owned by state-owned enterprises—Shanghai is much more dominated by private players.” Another investor said, “Beijing has [recently] been the star, with rents shooting up and retail doing well. It’s been a good market, but now they have this new government policy to get companies to relocate out of central Beijing, which will dampen demand a bit—so I’m probably less optimistic.”

Finally, “from a fundamentals point of view, it is attractive. But what makes me shy about Beijing is that there’s a bit more of the government hand there than there is in Shanghai. For some reason, I’ve always found that the ability of foreign investment managers to complete real estate transactions in Beijing is a lot lower than it is in Shanghai, and there’s probably a reason for that.”

Hong Kong (15th in investment, 14th in development). Hong Kong has languished in survey rankings since 2011. This is mainly because so few prime commercial assets ever trade on the market—and those that do are usually too expensive to interest international buyers. That may have changed somewhat in 2015, however. In interviews, several fund managers indicated an interest in buying in Hong Kong. In addition, two large hotel portfolio deals involving sovereign wealth fund buyers were concluded during the year.

According to one fund manager who made an unsuccessful bid on a Hong Kong asset during the year, “We were off by not much—it went to a level I would have still bought, but at a lower yield than I expected given the macro-environment. Obviously, there are a lot of people thinking the same way, so it’s telling you that the feel of the market is that, yes, there are some risks, but fundamentally, in a low-interest-rate environment I can’t sit on cash. If I have a decent asset with a reasonable spread and I think it’s good quality, I’m buying it.”

Perhaps ironically, however, just as investor interest in Hong Kong appears to have picked up, there also has been an uptick in pessimism about the local economy and markets. Although prospects for CBD offices continue to be boosted by a steady stream of Chinese financial companies setting up in Hong Kong, sentiment elsewhere has turned negative. For years, the local retail sector enjoyed the spending of a large influx of Chinese tourists willing



to spend big in Hong Kong's luxury shops. However, with mainland tourist arrivals down significantly in 2015, prime high street rents are now 26 to 43 percent lower than at their peak at the end of 2013, according to brokers DTZ. Investor interest is now directed at nondiscretionary retail assets.

Pessimism is also rife in the residential sector, which now features some of the highest prices in the world. Fears of an imminent increase in U.S. base rates have convinced many analysts that the market is about to reverse. Others, however, see the likely scale of rate rises as insufficient to make inroads on affordability. According to one locally based consultant, "My sense is that prices might plateau, but to start visibly to fall we would need to see an [interest rate] increase in the order of 2 percent, and we're a long way away from seeing that. I think if there is a vulnerability, it's more likely to be linked to what's happening [economically] in mainland China."

New Delhi (16th in investment, 11th in development). Real estate markets in northern India are generally weaker than those in the south, at least partly because they tend to focus on residential development, which is now experiencing oversupply. As a result, many Delhi-based developers struggling for cash have been targeted by foreign funds providing rescue capital. According to one foreign broker who



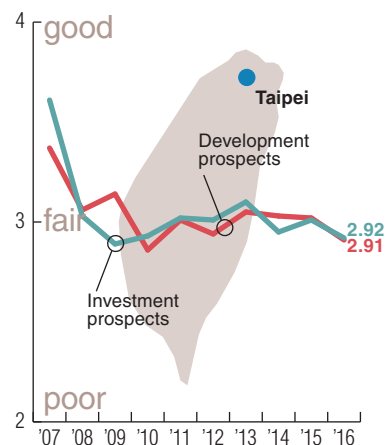
recently visited India, "All of the funds I met out there were talking about providing funding to local developers to do residential development."

On the office side, Delhi and nearby industrial zones have one of the biggest pipelines of new supply in Asia. They also have (at around 30 percent) some of the highest vacancy rates. On the ground, however, occupancy problems are focused on B-grade or secondary assets rather than the higher-quality buildings, for which demand remains high. According to one locally based interviewee, "Rentals are up, cap rates are down—both foreign and domestic institutional capital wants to buy these office spaces in large, good-quality buildings, so in the office space the trend is up."

Work is also continuing on the creation of the Delhi-Mumbai Industrial Corridor, a cornerstone project of the current government supported by Japanese capital that aims to develop eight international-standard industrial clusters between the two cities. According to one interviewee, "Down the road from Gurgaon, there's a lot of money flowing into industrial development and infrastructure creation, into areas where a lot of blue-collar and lower-middle-class demand is gravitating. That's where the institutional capital is now chasing demand—nobody is looking at the glamorous end of the market."

Taipei (17th in investment, 17th in development). In recent years, foreign investor interest in Taipei commercial property has faded after yields compressed to levels as low as 3 percent—among the tightest in Asia. Low yields have, in turn, been caused by years of buying by local institutions that have had few other viable options for investing their capital. Recent regulatory changes mean that significant insurance company money has now moved offshore into international markets, but prices in Taiwan remain high and foreign investor demand weak. While a substantial amount of new office space is scheduled for completion in 2015, this is not expected to significantly affect rents given recently strong uptake (especially from foreign companies) as well as the fact that as much as half of the new space is designated for owner-occupiers.

Taiwan's residential market has also seen considerable inflationary pressure, with prices tripling in the last 12 years, driven partly by capital inflows from mainland China. In June 2015, the government brought in new capital gains taxes aimed at deterring speculative investment. Taxes range from as high as 45 percent for homes sold within one year of purchase to 15 percent for sales more than ten years after purchase. Taiwan has thereby joined other regional governments—including Hong Kong, Singapore, China, and Australia—in



addressing the issue of high housing prices by way of macroprudential measures.

Shenzhen (18th in investment, 20th in development). The outlook for Shenzhen has probably been clouded by the general air of pessimism surrounding investing in China in 2015, together with incoming supply of some 6.3 million square feet (585,000 sq m) of new prime office space (representing almost 16 percent of existing stock) in the final quarter of the year. With even more new supply due to be introduced over the next few years, Shenzhen will probably soon overtake nearby Guangzhou as south China's biggest office market.

Notwithstanding the supply glut, however, most interviewees viewed Shenzhen positively. Office vacancies stood at only 5 percent at the beginning of the year. They are expected to rise as new supply is introduced, but absorption has recently been strong and the market is expected to be able to digest the new stock reasonably quickly. The recent creation of a new free trade zone in the Qianhai area of the city is expected to result in the migration of significant numbers of both domestic and international companies to the city.

On the ground, therefore, investor sentiment remains upbeat. As one Hong Kong-based fund manager said, "In

the south [of China], we think the Pearl River Delta will be very successful and will see big growth over the next ten to 15 years as it becomes interconnected. We would like to be there, but we haven't figured out how—there are still a lot of moving spaces about where the hotspots will be."

On the residential side, Shenzhen's market is traditionally the most volatile of any major Chinese city. Although prices were stagnant in 2014, the city certainly lived up to its reputation in 2015, as Shenzhen buyers reacted quickly to easing policies introduced by the central government. By the third quarter of 2015, home prices had risen 38 percent year-on-year, the highest in China.

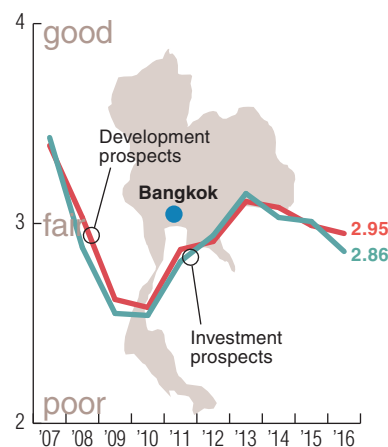
Bangkok (19th in investment, 16th in development). For at least the last couple of years, Thailand's political instability has been a disincentive for international investors. In addition, slowing economic growth, combined with recent instability in the Thai baht as capital moves out of the country in anticipation of U.S. interest rate hikes, has done nothing to increase confidence. Few interviewees indicated any interest in Thailand-based investments. That said, domestic liquidity remains high, and both capital values and cap rates in the office sector have continued to tighten steadily. With vacancies remaining low and relatively little new

supply expected in the near term, this seems set to continue.

On the residential side, the luxury market continues to see good demand, especially from foreign buyers, with record prices achieved for both land and condos. At the mid-market level, however, transactions have remained slow due mainly to oversupply and high levels of household debt.

Tourist arrivals were down in 2014 as a result of political conflicts that led ultimately to the military coup, but have rebounded significantly in 2015, with numbers up 25 percent year-on-year by the middle of the year. Increased tourism from China is the main reason for this. Occupancy rates have therefore recovered, although substantial new supply is expected in the hotel sector by the end of the year.

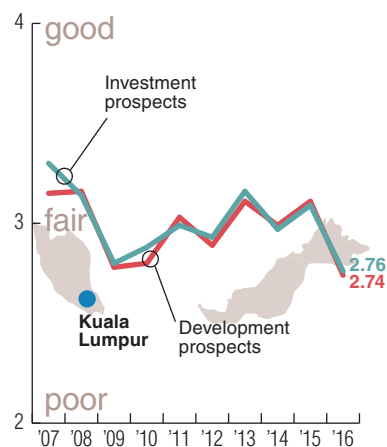
Guangzhou (20th in investment, 19th in development). Although it ranks as one of the four tier-1 cities in China, Guangzhou lags behind the other three in popularity. As one investor said, "I think Guangzhou is the odd one out to some degree. You're not seeing the level of demand or activity that you're seeing in the other three." Another commented, "It's a little too much the wild west for my taste." In any event, there is relatively little activity from foreign investment funds.



Over the last few years, prime office vacancies have declined steadily to about 7 percent at the end of 2015 as high levels of new supply were absorbed. But capital value growth and rents have never matched those in Beijing and Shanghai. In particular, rents remain at around half the levels of those cities. With a pipeline of some 6.5 million square feet (610,000 sq m) of office space expected to arrive in 2016—almost double current annual uptake—rents and pricing may again be set to stagnate. Investment activity is currently slow, with most buying occurring on a strata-title basis.

Kuala Lumpur (21st in investment, 21st in development). Malaysia cropped up quite often in interviews as a potentially interesting destination for fund managers. Current political uncertainty, together with a 25 percent decline in the value of the ringgit since the beginning of 2015, has created potential buying possibilities for more adventurous investors. As one analyst noted, “There are opportunities now that you wouldn’t see in a normal situation because there are eager sellers out of the Malaysian market. So without having to take a big bet, I think it would be an interesting time to look at Malaysia, particularly K.L. [Kuala Lumpur].”

This thinking is reinforced by relatively high cap rates on offer (for office, around 7 percent). In the second half



of 2015, one large foreign institutional investor entered a joint venture with a local developer for construction of a mixed-use project in K.L.

That said, most investors concluded that the situation was too volatile to justify investing at present. One manager commented, “Malaysia was on the radar, but there’s a tremendous amount of political uncertainty there and the currency is in a free fall.”

Currency volatility in Southeast Asia is usually seen as more of a negative than a positive because fund managers are generally reluctant to turn a property investment into a currency play. Another issue is that “most sectors in Malaysia are completely oversupplied and going to get worse in the next couple of years—it’s been a tidal wave of construction.”

While office values have run up significantly over the last few years, commercial property prices in Malaysia tend to be relatively stable. According to one fund manager, “The thing that keeps prices in Malaysia stable and quite high is the REITs, which are quite large relative to the size of the institutional market, and always just bid to the yields.”

Residential pricing, meanwhile, also has increased substantially (although to be fair, no more than in many other Asian markets), with the cost of high-end housing now becoming unaffordable for local buyers.

China second-tier cities (22nd in investment, 22nd in development). With the supply glut in Chinese second- and third-tier locations showing no sign of abating, there is little surprise that investor interest remains muted. The problem is not simply that too much supply has been built, but also that much of it is misconceived. One investor, speaking of the luxury retail sector, said, “I’m sure that given the size of Liaoning province there’s no



reason Shenyang can’t support one or two [luxury] shops. But 15 high-end places within a mile-and-a-half; are you kidding me?”

In addition, although some of the inventory has now been worked off, a considerable amount is still incoming. As one consultant said, “They worked some of it out, but in the meantime they’ve kept building. [That’s because] it’s very much a volume game. With net margins of maybe 0 percent to 5 percent, you really have to churn to get anything like a decent lump-sum profit. So the quantum they’re producing is greater and therefore the potential for inventories to grow to become a problem is there still.”

At the same time, while many foreign investors now will not touch anything outside of Chinese first-tier cities, if at all, significant numbers of opportunistic international investors with longtime experience in China see the dislocations in second-tier cities as more of an opportunity rather than a problem. For them, the buying prices are cheaper, or the cost of capital they provide is higher than it would otherwise be, or they suddenly have access to higher-quality deals that they would never normally have been able to tap. Risks are no doubt higher, but the possibilities for profit are elevated.



Property Types in Perspective

Industrial/Distribution

Shortages of modern distribution facilities across almost all markets ensure that demand will continue to grow, especially in China. Across Asia, the drivers are the need for rapid delivery from the booming e-commerce sector, buildout in the cold-food chain, and structural changes in regional manufacturing sectors as they migrate increasingly to frontier markets such as Vietnam, where logistics infrastructure remains primitive.

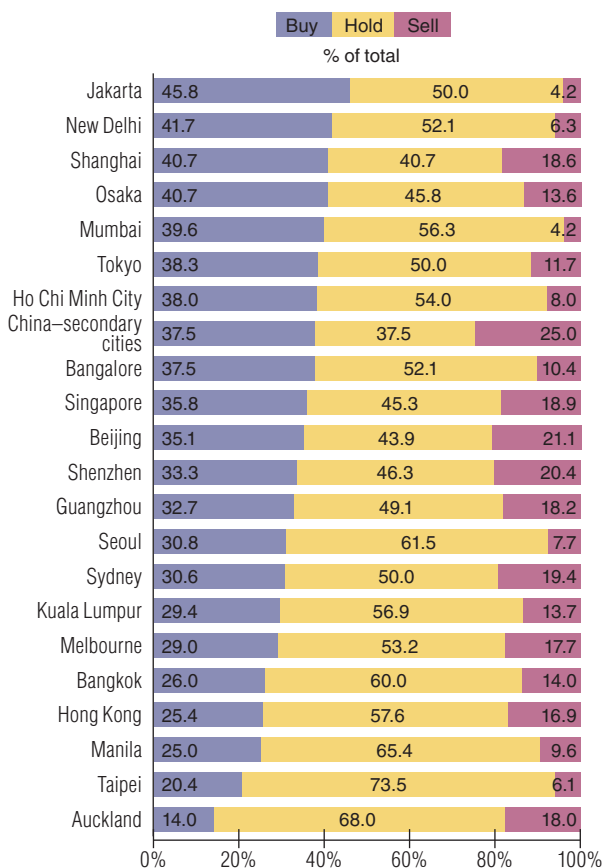
In practice, however, logistics is a complicated business and tends to be the preserve of specialist players. One fund manager, describing the sector in China, said, “It’s a very low-density use of land, it’s expensive to build, and local authorities are still wedded to the idea of selling land for the highest premium for the highest-density use, so they don’t like it.” On top of that, “you can build on spec, but a lot of logistics operators have quite specific needs, which means you have

to line up whoever you’re going to build it for before you get the land, which is difficult.”

Otherwise, investors voiced concern that there is now too much upcoming supply. This is already beginning to constrain both occupancy levels and rental growth, which has declined Asia-wide from double-digit figures five years ago to lower single-digit today. Pipelines are strongest in Tokyo, Shanghai, and Melbourne, according to CBRE. As one interviewee said, “Logistics now reminds me of the China story five to seven years ago—there’s so much money doing greenfield development. For build-to-suit, when you have your end users, that’s a great strategy. But otherwise, I do worry about the blind-pool investment that lacks experience in warehouse issues.”

Yields continue to compress regionally, having moved perhaps 200 basis points on average over the last 24 months. They currently range from around 7 percent in Australia, 6 percent in China, and 5 percent in Tokyo. Compression is expected to level off in 2016, however.

Exhibit 3-4 Industrial/Distribution Property Buy/Hold/Sell Recommendations, by City



Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

Best bets: Emerging markets feature prominently in this year’s buy/sell ratings for the industrial/logistics sector, in particular in Indonesia, India, and Vietnam. Demand in these countries is high, given the needs of expanding manufacturing sectors, especially in Vietnam. However, operational conditions remain tough. As one logistics specialist said, “Indonesia is too difficult. It’s a headache getting anything done, and there’s still plenty of opportunity in China. So I think it’s too early, it’s easier in other countries.” Another problem is the need to build in size: “There’s definitely a case for logistics as an asset class in Vietnam,” said another investor, “but I think logistics is a tough market to do anything in scale in developed markets already, so in Vietnam it would be difficult.”

In India, however, “you’re beginning to see demand for organized logistics space across the country from A-grade tenants who are willing to pay previously unheard-of rental for properties of good quality.” This is partly because of the growth of the e-commerce sector, but it is also a reflection of the increasing presence of foreign retailers, especially in northern India, who are demanding more sophisticated distribution networks. With institutional capital now beginning to invest in Indian logistics projects, rapid growth is expected.

One promising market mentioned several times in interviews is South Korea. According to one analyst, “It’s in the early stage of structural reform, and they’re going to follow the Japanese model. So far, the only smart institutional investors already in that space are the Singaporeans. Cap rates were double-digit last year. By the beginning of this year they were 9 percent, and now they’ve compressed to 7 percent, but they’re still

quite high. But no one is touching that market now; Korea's always been about office."

Residential

Eight years of low-cost capital have led to huge increases in housing prices in most Asian markets (major exceptions being Japan and South Korea), with many governments resorting to the introduction of high property transfer taxes as a means of putting a lid on speculative investing. Although the housing cycle is becoming long in the tooth, governments across the region (i.e., Australia, New Zealand, China, Taiwan, India) have continued to cut base rates in 2015. While fundamentals might suggest a reversal is on the cards, there is little downside pricing pressure while mortgages remain affordable.

Best bets: Japan again tops the list for this asset class, as it did last year. According to one Tokyo-based investor, "You have very good supply/demand balance right now in residential. There's no new construction, you still have people moving, occupancy rates are coming up, so now is the time to start moving rents. And we're starting to see that, we're getting rent growth in our buildings."

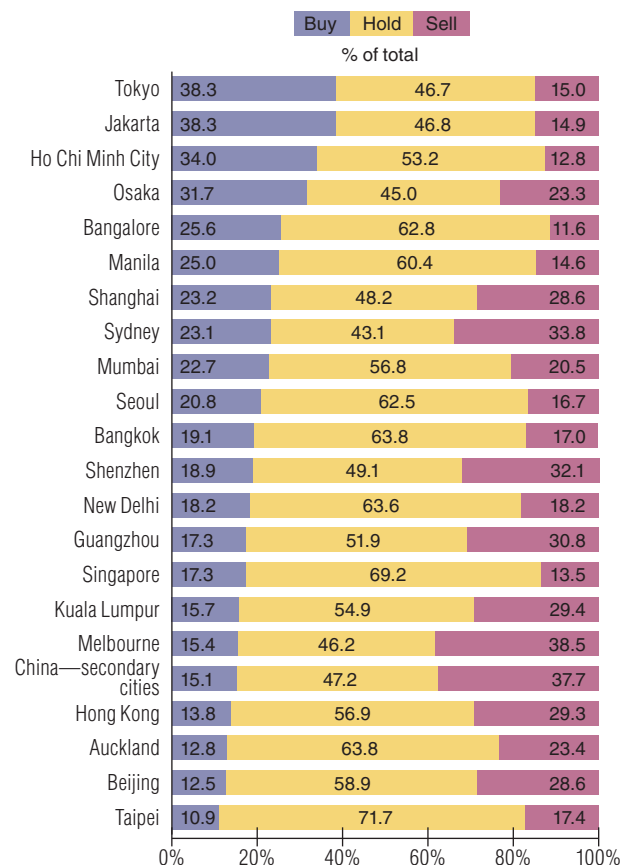
That said, emerging markets also featured strongly. Of these, Ho Chi Minh City is perhaps the most interesting. As the Vietnamese economy emerges from problems caused by several years of misallocated capital, the banking system has once again begun to lend money, sparking a rapid rebound in transactions and pricing. With recent regulatory changes now allowing foreign buyers (including a large contingent of foreign-domiciled Vietnamese nationals) to participate more easily, the prospects over the near term appear good.

India's popularity, meanwhile, stems from problems faced by cash-strapped developers, especially in the north, having trouble paying their bills. They have now been targeted by foreign funds looking to provide rescue capital on either an equity or a structured-debt basis.

Office

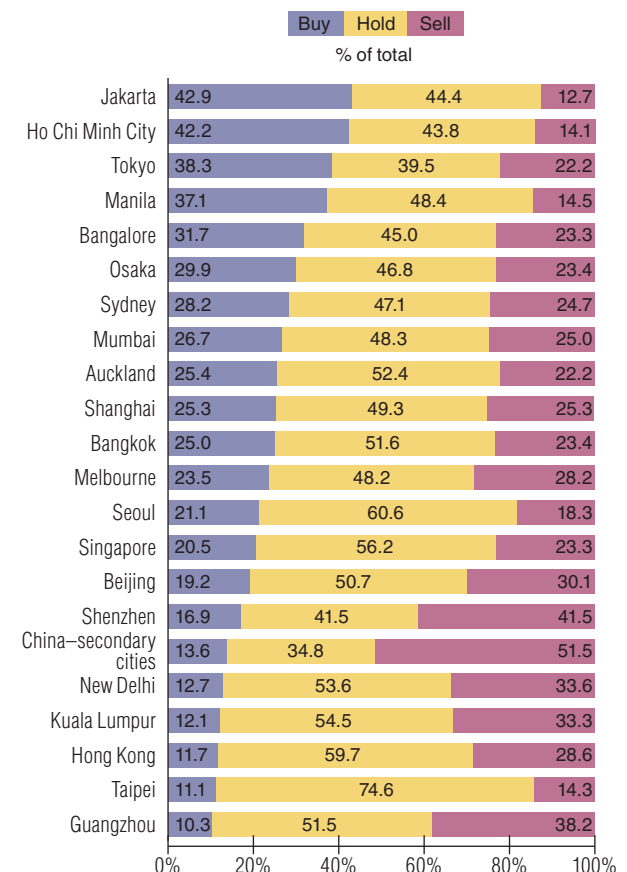
Office assets are a perennial favorite for conservative investors, but growing competition in this space as more and more institutional investors crowd into Asian markets means that it "seems a bit like hard work" for yield-driven players. Cap rates have continued to fall and capital values rise. This has driven

Exhibit 3-5 Apartment Residential (Rental) Property Buy/Hold/Sell Recommendations, by City



Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

Exhibit 3-6 Office Property Buy/Hold/Sell Recommendations, by City



Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

the popularity of some markets that in the past were seen as too difficult (South Korea), too remote (New Zealand), or too high-risk (India). Although many investors speak of rental growth as a means to provide further lift to regional markets, the sheer weight of capital now pointed at this sector gives little hope that cap rates will move out any time soon.

Best bets: The enduring appeal of the Jakarta office sector in the buy/sell rankings remains something of a mystery, especially given that demand has now fallen off, rents have plateaued for almost two years, and incoming supply is threatening a glut of new space. Still, the fundamentals remain good at the top of the market, where demand continues to be strong for international Grade-A offices with good connections to transport networks. A number of the region’s large diversified developers continue to be active with build-to-core strategies aimed at that space.

Otherwise, the story once again this year is the popularity of emerging-market cities. Vietnam certainly has demand for more office space, but the currently tiny size of that market leaves little room for trading of stabilized assets, while development is risky for the uninitiated. According to one fund manager, “Compliance risk is the issue, just in terms of whether you could buy from someone who had actually checked all of the boxes correctly, and had all the paperwork and the many, many boxes with sort of grayish edges. So, being able to come up with the proper approvals at the proper time so you could start construction and ultimately sell—that’s really tough.”

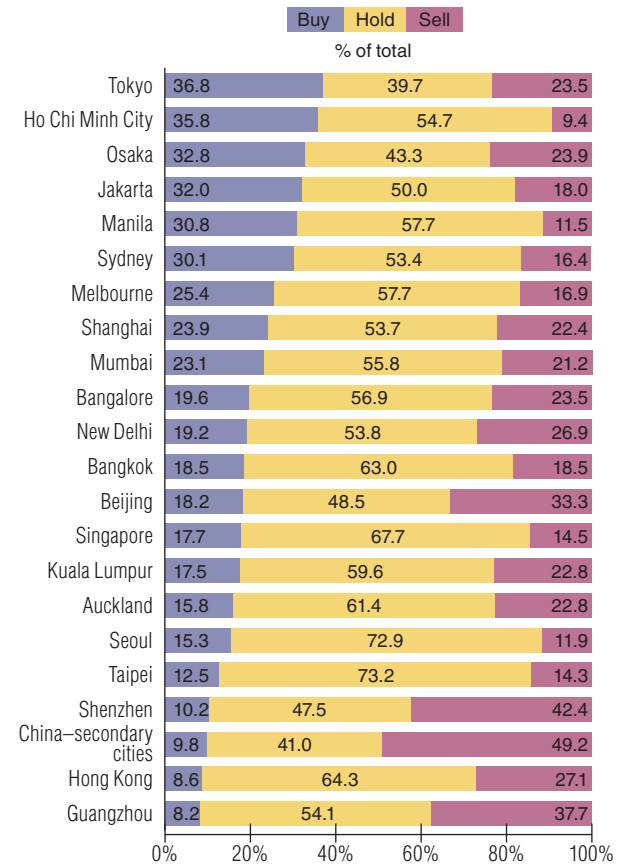
Finally, Manila also continues the rapid buildout of its booming office sector, driven mainly by the BPO industry. This is an area where many foreign investors would love to participate if only they could get a foot in the door. However, domestic liquidity in the Philippines remains high and with little need for foreign capital, access to this market continues to be difficult.

Retail

The underlying story for retail markets in Asia—the spending power of a rising middle class—remains in place. However, structural shifts within the industry are causing rapid change that can be hard to predict and even harder to keep up with.

First, developers in many emerging and developing markets have little experience in building successful retail space, leading to an oversupply of poorly positioned, misconceived shopping centers. According to one investor, “I find few well-done shopping malls, which are often done by developers with little experience. There’s a temptation to build very high-end malls where you don’t need them—I’ve seen so many malls, for example, across second-tier cities [in China] with branded French fashion retailers.”

Exhibit 3-7 Retail Property Buy/Hold/Sell Recommendations, by City



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Second, demand in many markets is now dependent on the traveling Chinese consumer, who may decide to go elsewhere on short notice. Hong Kong, for example, has in the past profited handsomely from Chinese tourists buying luxury products. This year, they have moved on to other destinations—in particular Tokyo—leaving a void in their wake. This underscores the growing disparity in Asia between different types of consumer spending.

According to one investor, “We have to separate nondiscretionary retail, which is highly correlated to GDP growth, from luxury retail. We see that with reasonably good GDP growth in the regions, necessity retail is the sector that will continue to have strength as new neighborhoods open up in cities. In contrast, luxury retail is probably overbuilt and undermanaged, and to the extent that it relies on discretionary spending, there could be weakness in the sector going forward.”

This applies in particular to China itself, of course, but also by extension to other markets where Chinese tourist money is appearing. It also represents a shift among investors toward

a more defensive mind-set, where the targeting of consumer necessities is seen as a preferable strategy to pursuing the high-margin luxury consumer who may be gone tomorrow.

Finally, the rapid rise of Asian e-commerce is changing the dynamic of retail malls across the region. As one fund manager observed, “The impact of e-commerce on retail will fundamentally change those assets. The shopping malls will operate differently, they will become entertainment lifestyle centers rather than just shops. The way that shops and mall operators can succeed in that is to integrate their operations with the bricks-and-mortar shopping.”

Best bets: The appearance of Tokyo and Osaka in first and third positions in this category comes as no surprise, and mainly reflects the growing tide of Chinese tourists making their way to Japan as a result of lower relative prices resulting from depreciation of the Japanese yen.

Emerging markets again make up the also-ran places, although their inclusion here is somewhat surprising given currently difficult operating conditions in their respective markets.

In Ho Chi Minh City, consumer sales growth may be extremely strong, but an already oversupplied market is currently facing a huge supply glut.

In Jakarta, there is a moratorium on new retail development, and anyway retail assets are mostly closely held and do not usually trade. According to one locally based investor, “The problem in Jakarta is that consumers don’t have the spending power that Singaporeans have, so you can have huge malls, but you can’t push tenants to pay more rent because there is no cash-rich consumer base. So everyone loves the retail story, but it’s not easy.”

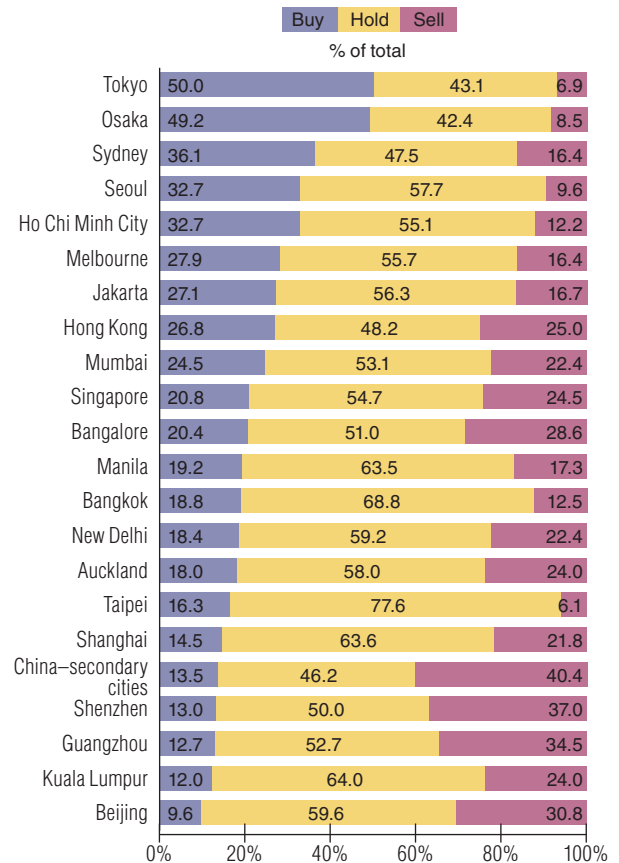
In Manila, the retail sector is performing well (especially at the convenience store level), but the familiar problem of getting access to the market remains.

Hotels

The relentless growth of intra-Asian tourism continues to create opportunities within the hotel sector, in particular for mid-level hotels that can cater to generally less-affluent Asian tourists, mainly from China. That said, a lack of supply means that prospects are good for the entire sector. Standout markets in 2015 have been Japan and Australia.

Still, the prospects for some locations are better than for others. Macau, for example, has floundered in 2015 as Chinese arrivals have fallen dramatically, at least partly as a result of the mainland government’s anticorruption campaign. Hong

Exhibit 3-8 Hotel Property Buy/Hold/Sell Recommendations, by City



Source: *Emerging Trends in Real Estate Asia Pacific 2016 survey.*

Kong also has been somewhat weak, partly because of a drop in Chinese tourists but perhaps more so as a result of the strength of the Hong Kong dollar, which is now significantly more expensive for regional tourists.

Japan again takes the top places. The reason once more is the huge influx of Chinese tourists to Japan combined with an overall shortage of stock. With demand also strong from buyers looking to make investments before the Tokyo 2020 Olympics, cap rates have compressed significantly and capital values have soared. Although many are still looking to get in, most of the profits in Japan have probably already been made.

The other best bet in Asia is probably Australia, and again the reason is the strong inflows of Chinese tourists, particularly in Sydney and Melbourne. As one investor said, “There’s a lot of money chasing good-quality hotel and office assets and a bit of movement there, too. We’ve seen record prices—a million dollars per room, mainly from Asian buyers in Sydney. But there’s also a lot of interest from the hotel groups chasing assets in the CBDs.”



Interviewees

AD Investment Management Co. Ltd.

Kenji Kousaka

AEW Asia

David Schaefer

Altis Property Partners

Alastair Wright

AMP Capital

Tim Nation

Angelo, Gordon & Co.

Jon Tanaka

Aoyama Realty Advisors Inc.

Haruyuki Shinya

Asia Pacific Real Estate Association

Peter Verwer

Aspen Property Group

Clem Salwin

AXA Real Estate Investment Managers**Japan KK**

Tetsuya Karasawa

BlackRock

Rio Minami

The Blackstone Group

Stuart Grant

Blackstone Tokyo

Wataru Goto

Brookfield Asset Management

Niel Thassim

Cache Logistics Trust

Daniel Cerf

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Henry Chin

CBRE Global Investors

Tetsuya Fujita
Richard T.G. Price

Cbus Industry Superannuation Fund

Adrian Pozzo

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Allan Fife

First Eagle Capital Advisors Private Limited

Sudarshan Bajoria

Folkestone Limited

Adrian Harrington

Fortress Investment Group

Akio Yamashita

Frasers Centrepoint Limited

Chia Khong Shoong

Fukuoka Realty Co. Ltd.

Etsuo Matsuyuki

Future Land Holdings Ltd.

Lu Xiaoping

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Danny Krefman

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Brett Robson

Mapletree Investments Japan K.K.

Norihiro Matsushita

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Wong Mun Hoong

Mercer

Padraig Brown

Mirvac

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Toru Tsuji

Mitsubishi Estate

Tetsuji Arimori

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Masami Amano

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Yutaka Imai

Mitsui Fudosan Investment Advisors Inc.

Ikuo Mori

Morgan Stanley (MSREF)

Chris Tynan

Mori Building

Hiroo Mori

The Net Group

Charlie Rufino

Nippon Rescap Investors

Ken Fridley

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Stephen Spohn

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Rajesh Agarwal

Springfield Land

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Standard Chartered Bank

Marc Bosnyak

Brian D. Chinappi

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Cover photo: Providing more than 355,000 square feet (33,000 sq m) of new office space in the central business district of Melbourne, Australia, 171 Collins Street is the city's first Property Council of Australia (PCA) Premium Grade office building in 20 years.

Image: Peter Clarke

Emerging Trends in Real Estate® Asia Pacific 2016

What are the best bets for investment and development in 2016? Based on personal interviews with and surveys from almost 350 of the most influential leaders in the real estate industry, this forecast will give you a heads-up on where to invest, which sectors and markets offer the best prospects, and trends in the capital markets that will affect real estate. A joint undertaking of PwC and the Urban Land Institute, this tenth edition of *Emerging Trends Asia Pacific* is the forecast you can count on for no-nonsense, expert insight.

Highlights

- Tells you what to expect and where the best opportunities are.
- Elaborates on trends in the capital markets, including sources and flows of equity and debt capital.
- Indicates which property sectors offer opportunities and which ones to avoid.
- Reports on how the economy and concerns about credit issues are affecting real estate.
- Discusses which metropolitan areas offer the most and least potential.
- Describes the impact of social and geopolitical trends on real estate.
- Explains how locational preferences are changing.