

# Emerging Trends in Real Estate<sup>®</sup>

Asia Pacific 2018



## **Emerging Trends in Real Estate® Asia Pacific 2018**

A publication from:



**Urban Land  
Institute**



# Emerging Trends in Real Estate®

## Asia Pacific 2018

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# Executive Summary

Of all the various influences that have combined to shape recent investment flows into Asian real estate, one continues to stand out: excess liquidity. Local sovereign and institutional funds bearing vast stockpiles of accumulated cash are investing it increasingly in property, both regionally and globally. The resulting competition for assets is changing the industry in fundamental and often unexpected ways:

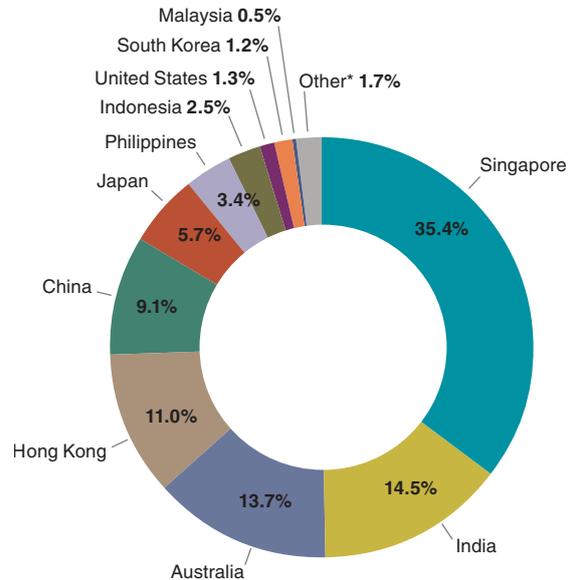
- Traditional risk/return classifications are breaking down. Many core investors are moving either up the risk curve (in an effort to meet target returns) or down the risk curve (in order to seek the type of steady but safe yield no longer available from sovereign bonds).
- Opportunistic investors are also changing their return expectations, usually downwardly. As one investor said: “It’s actually been happening for a while now; it’s just that every year a few more of them slip down the risk curve.”
- Core and opportunistic investors are converging in the value-add space. Increasingly, therefore, investors are looking to make money from working their assets rather than via leverage or rental growth (which is anyway now slowing in many markets).
- Another byproduct of increased competition for assets is an investor migration into markets and asset classes that in the past did not receive much interest. In particular, fund managers are now willing to look at data centers, affordable housing projects, build-to-rent (or co-living) facilities, and student and senior housing.

Another trend quickly gaining traction across Asia is the boom in shared workplaces, with coworking operators now the biggest demand driver for new office space in many cities across the region. Such is the pace of change that both landlords and investors are having trouble coming to terms with it. The consensus, however, is that changes to workplace use are here to stay—landlords should grasp the nettle to devise operating models that will allow them to profit from these changes rather than treat them as a passing fad.

Meanwhile, developing markets in Asia continue to draw investment interest. Vietnam and India were the standouts in the interviews and survey—the latter in anticipation of high and long-term economic growth, the former for similar expectations regarding economic growth combined with a lower base and the vast scale of investment opportunities on offer.

Investor concerns about how the Asian retail sector is going to weather the challenge from e-commerce in the wake of numerous mall failures in U.S. markets were reflected in our survey’s sector prospect ratings, where retail placed last. That said, interviewee opinions were quite polarized, with some suggesting that regional retailers will be able to deal

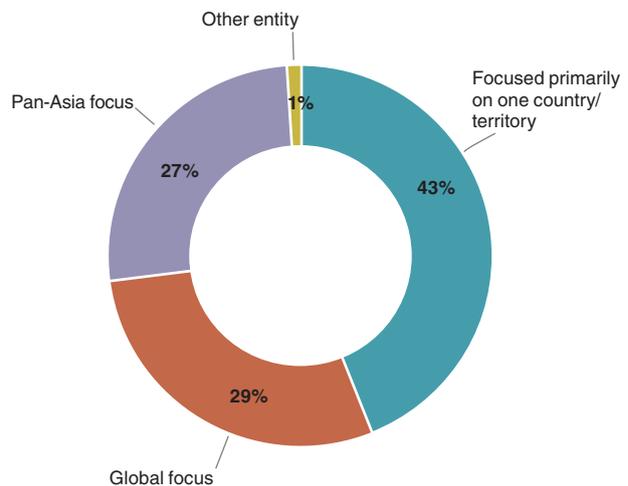
## Survey Responses by Country/Territory



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

\*Includes Germany, Vietnam, Fiji, Netherlands, New Zealand, Taiwan, Thailand, and the United Kingdom.

## Survey Responses by Geographic Scope of Firm



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

with the challenge by changing tenant mixes, investing in neighborhood retailing facilities (which are less threatened by e-commerce sales), and leveraging technologies such as heat mapping to increase mall efficiency. Others, however, were less sanguine, taking the view that landlords have underestimated the e-tailing challenge and continue to misinterpret consumer preferences.

In terms of capital flows, the ongoing exodus of money from Asian institutions—mainly in the form of local sovereign wealth funds and insurance companies—has continued to grow in 2017. This, despite a crackdown by regulators in China (by far the biggest source of regional outflows) that has now blocked a large amount of Chinese capital from moving into international markets.

The impact of this as far as Asia is concerned tends to be restricted to investments by Chinese developers, in particular in Australia, where local interviewees reported the possibility of stress among Chinese investors no longer able to source capital to finish ongoing development projects. Long term, however, there was a consensus that capital flows from Asian markets will probably only increase, given that local markets lack the capacity to absorb the sheer volume of funds that institutions need to deploy.

As far as capital markets are concerned, regional banks remain the go-to source of funding for investors and developers in almost all jurisdictions. However, most interviewees reported that while capital was in most cases readily available, banks are also beginning to tighten lending requirements in some markets, in particular in Australia and China. This may create some “interesting investment pipelines” for the future, according to one investor, including provision of mezzanine debt. As a result, a growing number of investors are now looking to set up debt funds in order to supply alternative sources of capital to those who may not be able to source it from banks.

The bloom has come off regional real estate investment trust (REIT) markets this year as higher interest rates dim the attraction of an asset class that tends to trade in line with fixed-income assets. However, of the three major markets, only Japan registered a significant downturn. Some investors predicted an increase in the number of REIT takeovers in the region after private players bought out several smaller regional REITs in the first half of 2017. Finally, after several years of speculation, India seems primed to launch its maiden REIT in early 2018, providing a long-awaited exit strategy for investment funds now active in the market or thinking of entering.

This year’s investment prospect rankings reflect a growing divergence between investors embracing either growth- or yield-driven approaches. Cities that were the biggest gainers in this year’s survey were therefore those that offered significant rental growth (Sydney and Melbourne), returns that were low but still higher than yields on sovereign bonds (Tokyo), or long-term secular growth in emerging markets (Vietnam). In addition, there was a huge resurgence in investor sentiment toward Singapore, which appears to have found a bottom in both the office and residential sectors.

In terms of prospects for individual property types, logistics assets take pole position this year, with investors showing renewed confidence in a story of long-term structural under-supply. As one fund manager put it: “The supply/demand dynamics for contemporary modern logistics in Asia still seems pretty good, and my guess is that it’s got legs.”

## Notice to Readers

*Emerging Trends in Real Estate® Asia Pacific* is a trends and forecast publication now in its 12th 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 2018*, 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 2018* reflects the views of 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 more than 110 individuals and survey responses were received from almost 600 individuals, whose company affiliations are broken down below.

Private property owner or developer ..... 25.5%  
 Fund/investment manager ..... 24.4%

Real estate advisory or service firm ..... 19.7%  
 Homebuilder or residential developer ..... 9.1%  
 Institutional equity investor ..... 6.3%  
 Bank lender or securitized lender ..... 3.0%  
 Other entities ..... 12.0%

Throughout the publication, the views of interviewees and/or survey respondents have been presented as direct quotations from the participant without attribution to any particular participant. A list of the interview participants in this year’s study who chose to be identified appears at the end of this report, but it should be noted that all interviewees are given the option to remain anonymous regarding their participation. In several cases, quotes contained herein were obtained from interviewees who are not listed. Readers are cautioned not to attempt to attribute any quote to a specific individual or company.

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.

# An Embarrassment of Riches

**“One of the things that the increase in capital has created is a premium on execution capabilities. And one thing is for sure: a lot more work is needed to generate the same returns.”**

As ever-growing flows of global and (especially) local capital continue to pour into real estate markets across the region, competition to buy assets in major Asian markets has reached unprecedented levels. What’s more, with base rates remaining low and yields on sovereign bonds showing no sign of rising any time soon, pressure is only rising for more of Asia’s huge capital reserves to rotate into higher-yielding assets, and in particular, property.

This excess of abundance is making life increasingly difficult for anyone looking to invest in Asian real estate. More buyers not only mean more competition, higher prices, and lower yields. They are also leading to increased appetite for risk and a growing exodus into alternative markets and asset classes that normally would not register on investors’ radars.

Beyond this, the apparently irreversible flood of new capital into Asian real estate has led to an evolution in the way that deals are being sourced and executed. According to one fund manager: “In the past, when we picked investments we would just say, ‘This is China, so we expect capital values will go up.’ And you just found whatever you thought met the requirements and then made the investment—it was a very macro-led strategy.”

Today, that has changed. As another investor said: “We’re still targeting to generate 20 percent returns on opportunistic risk, but we’re seeing a much greater component of that 20 percent coming from current income rather than total return or cap rate compression. That means you are now having to look harder to find those types of opportunities, and you’re having to work the asset a lot harder to enhance the cash flows.”

One investor, for example, described how much harder it is today to find deals in the Japanese logistics sector: “We’ve been there for 15 years. Back in the early days, you could buy a piece of industrial land, put a warehouse on it, and

deals were fairly easy. Then all the money flooded into Japan, everyone is looking at logistics, and now there’s no easy land to buy. So, we went into buying contaminated land—we buy it, clean it. It’s a messy process, but then you have a nice piece of land just where it needs to be. But most of the lighter money that’s recently come in is afraid to touch it, and it’s only experience that allowed us to do that. So, you have to keep going in a little deeper to find those opportunities.”

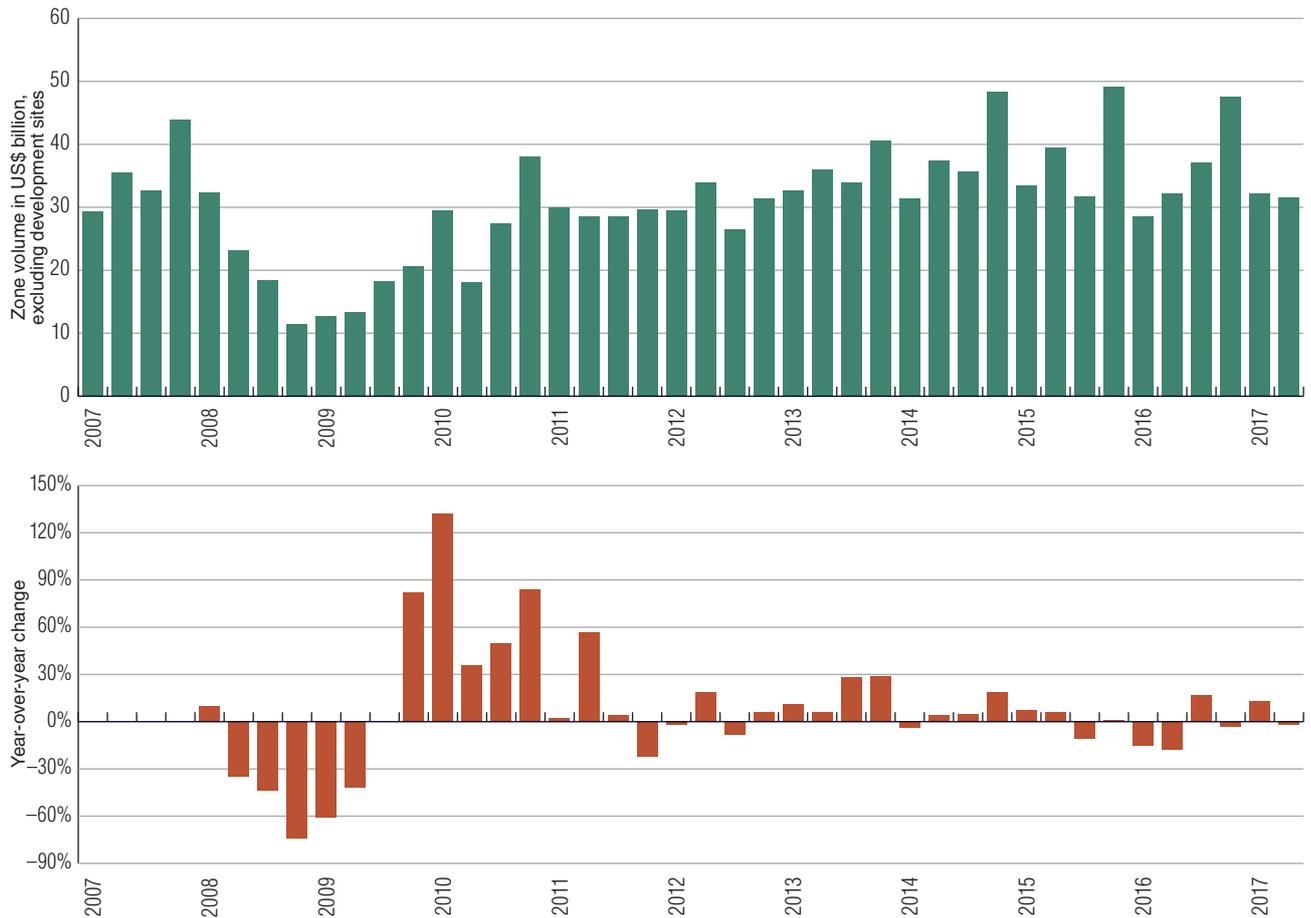
## Transactions Slow in Major Markets

Another byproduct of today’s low-interest-rate, high-liquidity markets is that—paradoxically—they create less incentive for property owners to sell, especially when the asset is a core holding in a major market. This is not only because owners believe (probably correctly) that a buyer-rich environment will eventually deliver compliant purchasers, but also because they fear (again, probably correctly) that if they do sell, they will be unable to find a better way to invest their capital.

Weakness in core market transactions first emerged in 2016 and has continued into 2017, with a small number of large transactions making overall activity appear stronger than it actually was, according to market analysts Real Capital Analytics (RCA). This is fueling a general expectation that major markets will remain soft going forward, a feeling reinforced by the conviction that banks in some markets have now begun to tighten lending requirements.

Annualized commercial sales volumes for the first half of 2017 were notably down in Asia’s two big core markets: Australia (–35 percent) and Tokyo (–33 percent), according to RCA. Equally noteworthy was the increase in transactions (i.e., by 14 percent) for Japan as a whole, as more capital rotates away from staple assets in Tokyo and into the provinces. This reflects an Asia-wide theme of investment flows migrating to less-traveled areas.

**Exhibit 1-1 Transaction Volumes of Income-Producing Assets, Asia Pacific**



Source: Real Capital Analytics.

Sales in Hong Kong soared in 2017, due in large part to a number of large land and asset deals involving Mainland Chinese capital. Singapore saw a 50 percent pickup in investment following a number of large deals, while development site activity has also been strong, signaling anticipation of a market bottom after several years in the doldrums.

Transactions in China, meanwhile, rose a healthy 11 percent (and rather more in tier-one cities), due at least partly to the impact of tightened capital controls that are redirecting investment otherwise destined for international markets back into domestic assets.

### Core Buyers Take More Risk

As competition increases, cap rates flatten, and the number of available assets declines, more core investors are opting to migrate up the risk curve in search of yield, most obviously via development projects. While this may represent, as one fund manager put it, a “classic mispricing of risk,” today there

is greater acceptance among core investors of strategies that create new product via build-to-core or forward-funded projects, the rationale being that the growing number of institutional and sovereign funds looking to place capital provide a ready exit for this type of play.

The emergence of this trend has been most pronounced in China, where domestic insurance companies are happy to pay prices considered excessive by global standards in order to get money into the market. As one investor observed: “They say their challenge at the moment is not near-term returns, it’s long-term access to investment stock that will generate returns when their actuarial models shift from having been recipients of funds to being payers of benefits. And at the moment, their inflows are such that they say, ‘I’d rather overpay today to be invested in something I feel good about owning over the next 20 years than to get stuck in cash and miss out on owning stuff that will provide for my policyholders in the long term’—and that’s not completely illogical.”

Exhibit 1-2 Sales Volumes for Most Active Global Real Estate Markets, First Half 2017

2016 rank	1H 2017	Market	Sales volume (US\$ million)	Year-over-year change
1	1	NYC metro	20,180	-40%
2	2	Los Angeles metro	15,112	-7%
4	3	London metro	14,759	0%
3	4	San Francisco metro	11,866	0%
12	5	Hong Kong	8,269	5%
14	6	Boston metro	8,064	1%
8	7	Dallas	8,010	27%
7	8	DC metro	7,783	-3%
10	9	Atlanta	6,515	27%
6	10	Tokyo	6,207	-33%
13	11	Shanghai	5,854	43%
22	12	Singapore	5,801	50%
11	13	Miami/South Florida	5,699	-33%
16	14	Amsterdam/Randstad	5,262	6%
20	15	Berlin-Brandenburg	5,041	11%
28	16	Frankfurt/Rhine-Main	4,954	58%
23	17	Rhine-Ruhr	4,928	78%
25	18	Houston	4,918	41%
9	19	Chicago	4,683	-38%
5	20	Paris	4,568	-56%
15	21	Seattle	4,289	-26%
27	22	Madrid	4,190	59%
24	23	Austin	3,818	3%
21	24	Phoenix	3,678	-16%
19	25	Seoul	3,631	16%
18	26	Denver	3,469	-42%
40	27	Charlotte	3,390	48%
17	28	Sydney	3,279	-30%
39	29	Orlando	3,260	45%
108	30	Yokohama	2,998	566%

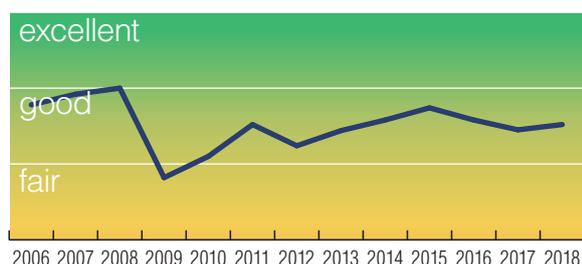
Source: Real Capital Analytics.  
 Note: Includes office, industrial, retail, apartment, and hotel properties.

Nor is development the only way to boost returns, with many core investors now also opting for core-plus or value-add plays as a way to generate extra yield.

Another new trend for core money is to revisit markets that in the past it avoided, both to diversify and because they may have more available assets. Hong Kong, for example, has for years been marginalized by most international investors because its central business district (CBD) stock rarely trades; and when it does, it is generally picked up by Mainland Chinese buyers prepared to pay higher prices for flagship products. But transactions in Hong Kong have been robust in 2017 and, anecdotally, a number of core funds are now actively looking to invest, focusing on non-CBD assets with longer-term growth potential. Basically, this reflects capital flight from other core markets where assets either are not readily available (Australia) or rental growth prospects have dimmed (Tokyo).

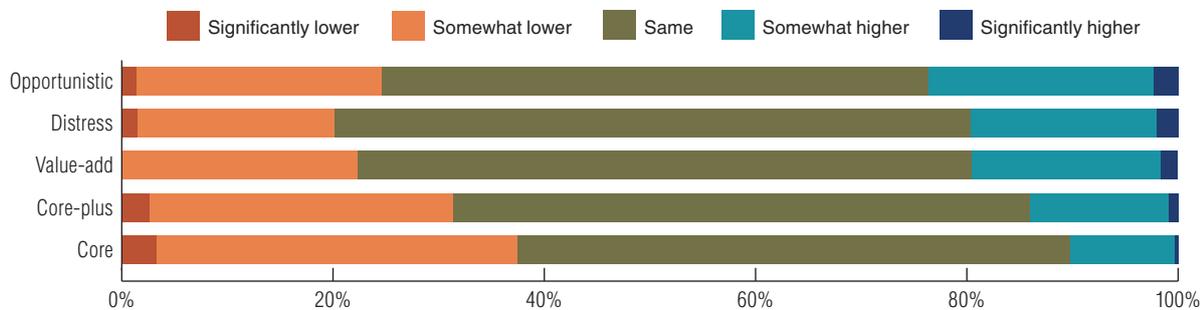
According to one locally based fund manager: “It will be interesting to see whether the multitude of core funds out there that have been investing in Sydney and Tokyo over the last five to ten years can make a case for buying now in Hong Kong. I think some are trying to. One of the funds we’re selling to at the moment is a core/core-plus fund. Overall returns in Hong

Exhibit 1-3 Real Estate Firm Profitability Trends



Source: Emerging Trends in Real Estate Asia Pacific 2018 survey.

### Exhibit 1-4 Change in Targeted Returns Compared with 2017



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

Kong probably aren't the same as they're expecting in Sydney and Tokyo and the risk profile is greater, but it's a diversifier to what they've already been doing in Asia, and I think they're trying to justify it on that basis."

Seoul's star has also been rising among core investors, particularly in the office space, mainly because "yields are not crazy-low like they are everywhere else. There's significant foreign and domestic interest for buying anything that is new with a stabilized income stream, and people are attaching a pretty low yield to it. I'm not sure Korea is a huge growth story, but I think people are looking for overall exposure in that market as a part of an Asia Pacific plan."

Singapore, meanwhile, is seeing resurging interest as funds begin fishing for a bottom in the market. According to one local fund manager: "As far as the office market is concerned, you are seeing a bit more demand coming in, and there's some pretty low-priced space for some pretty good quality. But it may be premature—there's been that huge shadow space from the banks that has now shrunk, and there's a lot of other space that's not being used—people have had to downsize because those coworking spaces are starting to have some traction."

### Core Buyers Take Less Risk

The migration of some core investors away from what normally would be considered core-type risk is not one-way traffic. So, while plenty of managers are now willing to go up the risk curve, there are also equal if not greater numbers headed in the opposite direction, looking for conservative investments that on paper will generate lower-than-normal core proceeds. Survey results confirm that investors are expecting a bigger drop in core returns than they are for any other asset class. This is also in line with a global trend of shrinking returns for institutional capital, which have fallen from an average of 11 percent in 2015 to 8.6 percent in 2016, according to a recent study published by real estate advisory firm Hodes Weill.

Those willing to adopt more risk tend to be either existing funds that need to hit preexisting targets (or at least not dilute current earnings), while those in the safety-first camp are usually those with either longer duration or lower cost of capital looking to play the yield spread—that is, assets that will generate long-term reliable yields of around 300 basis points over those offered by local sovereign bonds. According to one analyst: "People are fixated on that spread and that's what's driving money into real estate. As much as people want their growth in the rent and GDP, at the end of the day people like the big pension funds and the big insurers have increased allocation to real estate because of this spread between the two."

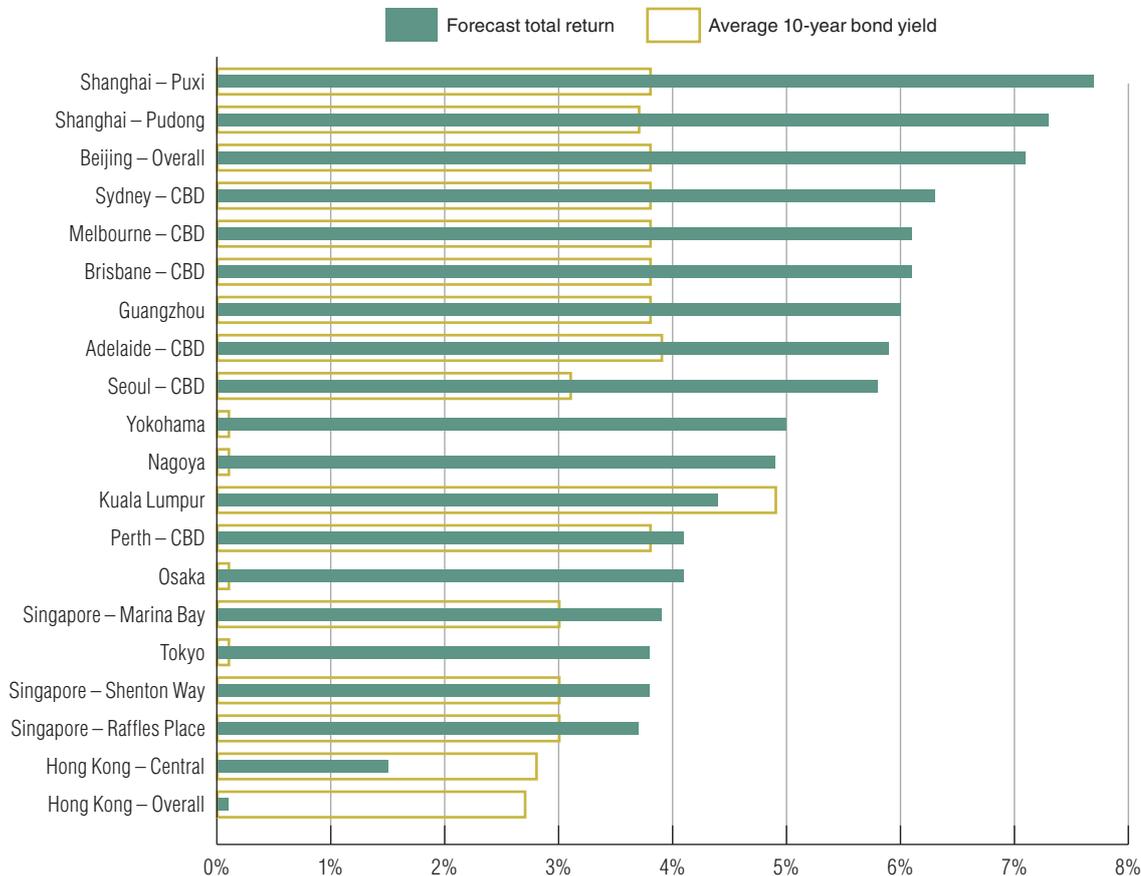
At present, there is no shortage of this type of buyer. Quite apart from the vast amounts of newly arriving capital run by Asian institutional and sovereign wealth funds, significant amounts of private Asian money also are seeking a safe home. According to one fund manager active in Japan: "We've recently been selling smaller, well-let, good Japanese corporate-covenant assets to high-net-worth domestic buyers who price totally different to institutions—they're happy with a yield of three and a half. It's not 'front of the annual report' quality real estate, but we've been astonished by the depth of liquidity even in provincial Japan."

### Opportunistic Returns Continue to Fall

Nor is core the only space where investors are being squeezed out of traditional risk/return classifications: opportunistic buyers are also being forced to make downward adjustments to return expectations. According to one Hong Kong-based fund manager: "What our investors are demanding on the opportunistic side is coming down. People used to say plus-20 [percent]; now it's plus-15 to 20 [percent]. And it's actually been happening for a while now; it's just that every year a few more of them slip down the risk curve."

As with those core funds now opting to adopt development strategies, many opportunistic funds are today focused on manufacturing an end product that can be sold to an institu-

Exhibit 1-5 Office Assets, Projected Compounded Annual Return, 2017–2021



Sources: Oxford Economics, Deutsche Asset Management, as of January 2017.

Note: RC = regional center; SRC = subregional center. Spread over sovereign bond is determined by projected income return plus capital appreciation.

tional buyer, be it a single-building asset or something in an alternative asset class such as a data center. This strategy is especially effective in destinations where there is a large gap in values between Grade-A and Grade-B products, such as Hong Kong, or where the local market has intrinsic inefficiencies that can be arbitrated to create products more aligned with what end users are looking for. This includes South Korea, where “the economy is very mature, but the real estate, physically, is quite old.”

The reason for the overall decline in opportunistic returns is again a result of yield compression—as cap rates fall for all the usual reasons, the risks that attach to the traditional 20 percent-plus opportunistic return profile have risen. As one investor put it: “The big challenge is the continuous disconnect between the risk that opportunistic investors want to accept and the returns they are looking to get. We still see across almost all of our Asian markets that there’s not an appreciation for how much risk you need to take to get your targeted returns. The only way to mitigate that risk is to take a return threshold that’s slightly lower on a risk-adjusted basis.

I think doing that puts you in a much better place, but it’s very hard to convince people because of the pigeonholing mentality between core and value-add and opportunistic.”

That said, plenty of opportunistic funds continue to target traditional 20 percent-plus returns. Quite often, they are able to do so because they have people on the ground with good knowledge of local inefficiencies in particular markets or specific assets. Lateral thinking may be required. As one analyst observed: “That’s opportunistic today—creative thinking about how to enhance return.”

Again, however, there need to be idiosyncrasies in the market that create differentiations to be exploited. As one interviewee said: “We find we can get good opportunistic returns in markets that are not quite as transparent as others. In Japan, for example, where things are not as clear on assets as they would be in Hong Kong and Singapore, you can find the niche players willing to sell a piece of property a little under market to keep his name out of the papers sort-of-thing, and if you’re well positioned you can find that and get that plus-20

[percent] pretty easily. But in markets that are very transparent and everyone knows everything about anything, then returns are significantly lower.”

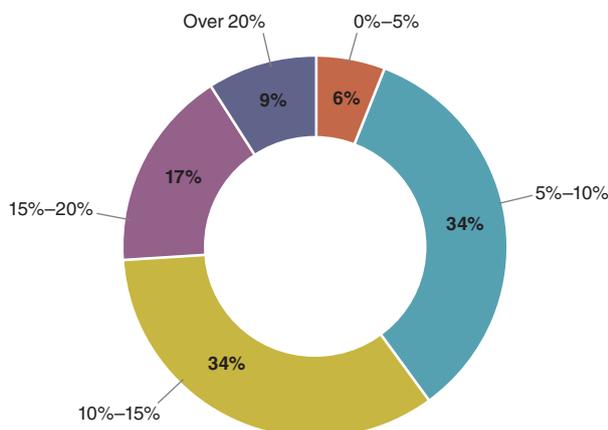
## Core and Opportunistic Converge on Value-Add

What all this means in practice is that a growing amount of capital from both core and opportunistic funds is now converging on the value-add category. According to the manager of one value-add fund: “What we’re seeing now is that the value-add space where we’re active, unfortunately, is getting more entrants, partly because some of the traditional players in the opportunistic space are now moving down the risk curve. So, value-add is increasingly both a high-risk core strategy or a low-risk opportunistic strategy.”

In some ways, this is a happy coincidence because there are now increasing numbers of properties in Asia built around 15 to 20 years ago that can benefit from repositioning as part of a value-add strategy, providing exactly the type of asset management play that can deliver target returns.

Old assets that are either out of date in themselves or whose environs have evolved in ways that may allow assets to be repositioned are therefore something of a sweet spot in the market. As the same value-add manager recounted: “We bought an office building two minutes’ walk from [Sydney’s] Barangaroo. It’s an old building, and we’re going to do a lot to it. But the building is out in the middle of nowhere, so no Barangaroo, no project. And as you get more of these great premium Grade-A developments in cities around Asia, and all this new infrastructure development going on, all of a sudden buildings that five or ten years ago were uninteresting become really interesting. They’re old; you can do something with them.”

**Exhibit 1-6 Investors’ Targeted Returns between Now and End of 2018**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

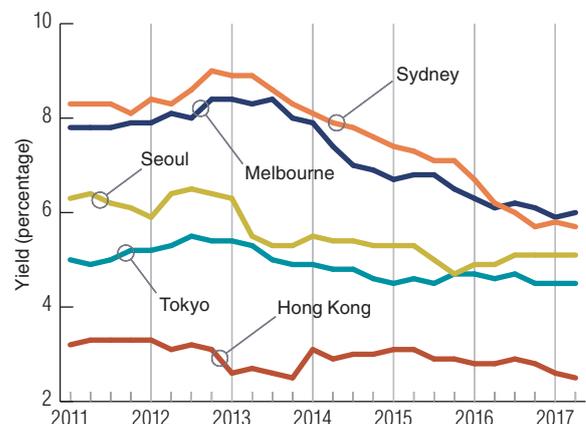
At the same time, as more capital drifts toward the midpoint, the traditional differentiation between various investment strategies has begun to break down, in the process creating a new type of risk: “I think the lines between value-add and everything else is thinning,” said one interviewee. “We see people who say they’re in the value-add space who want to reposition an old decrepit mall. To me, that’s a much riskier play than choosing a greenfield site to build an office building, but they say that’s in their 10 percent to 15 percent space. So, the definition of what they say they want to invest in and the risk profile that they attribute to that is all getting very blurred.”

## Rental Growth Slowing?

Another reason that there is now such a focus on using asset management to deliver returns is that some investors have lost confidence in rental growth to operate as a catalyst. Tokyo, for example, has seen an exodus of foreign investors from the office sector for precisely this reason, and many analysts are now projecting that both capital values and cap rates have reached a threshold in many Asian markets as a result.

At the same time, there seems plenty of growth left in some markets. An expectation that Australian assets will continue to see strong rental growth over the near-to-medium term is one of the main reasons they continue to be popular. Another source of long-term rental growth is likely to be in developing economies. While these obviously involve more risk, institutional investors are increasingly willing to invest in emerging markets provided they have the depth to absorb large amounts of capital. For many, this means India. As one such investor said: “We feel the real diversification offered by Asia is to invest in emerging markets where there is a long-term, sustainable, 3 percent to 5 percent rental growth profile over a long period. That’s the key characteristic; we don’t see that anywhere else in the world.”

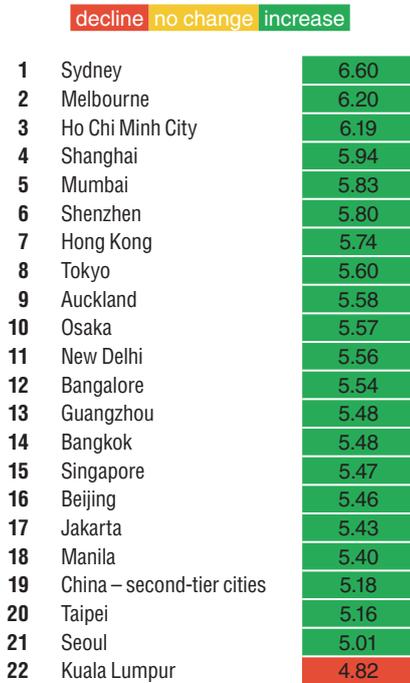
**Exhibit 1-7 Asian Office Transaction Yields, 2011–2017**



Source: Real Capital Analytics.

Note: Figures are 12-month rolling average.

Exhibit 1-8 Cities Most Likely to See Rental Growth in 2018

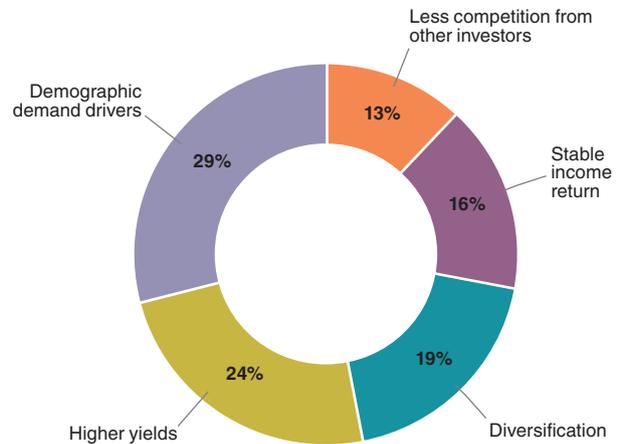


Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey*.  
 Note: Scored on a nine-point scale.

### Alternative Assets Pick Up Steam

Another way for investors to boost returns is by migrating to unconventional asset classes, where competition is thinner and yields higher. While this is not a new strategy, the shift toward niche investments is more pronounced this year, with investors increasingly willing to take a punt in areas they previously avoided due to the perception of higher risk or the need for specialist operational expertise. According to one investor: “You really have to find a good operator together with the real

Exhibit 1-10 Reasons for Investing in Niche Sectors



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey*.

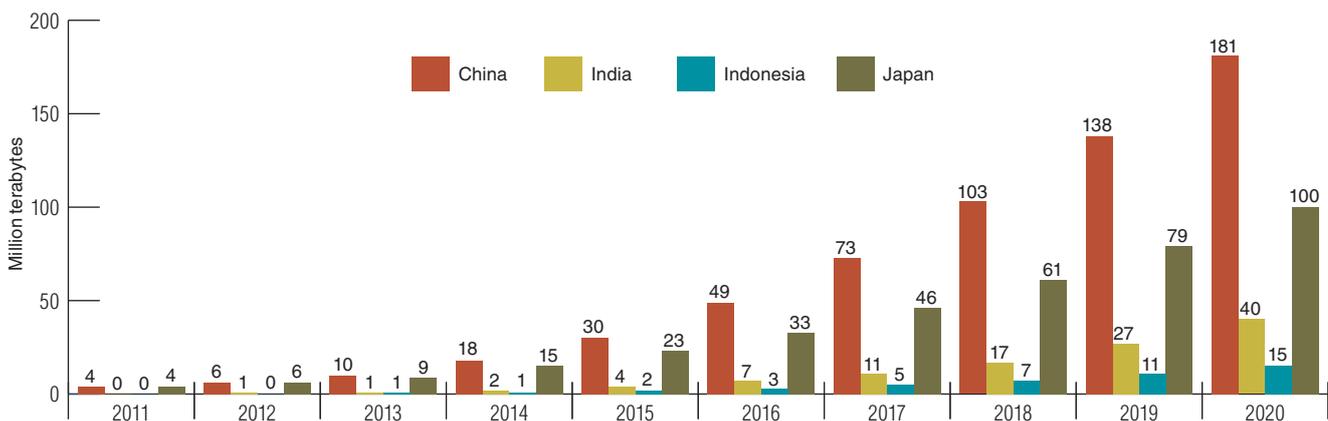
estate. If you can do that, you should be able to get an edge on your margin than just buying a core office building—some-where up in high single digits rather than low single digits.”

This year, the following types of alternative assets are gaining favor.

### Data Centers

In the past, this area was considered just too specialist. Today, however, significant numbers of interviewees, including institutional funds, said they were willing to consider it, usually in partnership with a professional operator. One reason for this is that Asia’s data center market is quite fragmented, creating scope for merger-and-acquisitions (M&A) activity. Supply/ demand dynamics are also positive, with current shortages in regional capacity complemented by likely vast increases in

Exhibit 1-9 Data Consumption in Selected Asia Pacific Countries



Source: PwC’s *Global Entertainment & Media Outlook 2016–2020*.

## China: Key Themes

Over the last couple of years (most recently in mid-2017), the Chinese government has gradually tightened controls over outflows of domestic capital in an effort to prevent irresponsible investment in foreign markets. One unintended consequence of this has been to redirect a large body of domestic funding originally earmarked for investment in international real estate back toward domestic assets, making China's already tight property markets even tighter.

As a result, cap rates in first-tier cities compressed significantly in 2017, with Shanghai offices trading at around 3.5 percent going into the final quarter, according to JLL. Investors active in Chinese markets reported sharply rising asset prices. "Core office is on fire right now, yields are trading as tight as we've ever seen," said one fund manager. "Overbidding is crazy," commented another. "Prices on the stuff we're trying to do are just amazing—in the last six months, they've gone through the roof."

Nor is pricing the only drawback for foreigners. Familiar issues such as regulatory risk (now considered a "key determinant" by one interviewee), short lease structures, tenant credit quality, tax liabilities, oversupply problems, and repatriation of profits continue to weigh on prospects for international capital.

Beyond that, deals are becoming even harder to source than they were. According to one foreign fund manager:

"A lot of investors are trying to figure out how to make money in China over the next five to seven years because it's going to be very different to how people have made money in the past ten years." The residential space is no longer an avenue for easy profits because margins have shrunk dramatically in recent years, while in the commercial space, core assets have always been in short supply because so much commercial stock is held on a strata-title basis.

This problem applies equally to opportunistic investors, but has been amplified recently because, according to one fund manager, China's growing economic maturity means there is now less differentiation between available assets that can be used to arbitrage inefficiencies. "The theme in China has to be finding differentiation, because the days of making good margins on building commodity stuff have passed. But the challenge with B-grade office, for example, is that everything is good enough. Infrastructure is fine, services are pretty efficient, things work. So it's much harder to find something that can be repositioned in a way that drives profit."

As a result, investors in general are searching further afield for buying opportunities. These may include investments in alternative asset classes such as self-storage, student housing, or data centers. Bigger players are buying at the entity level or partnering with local governments in urban regeneration or new township developments. On

future demand as corporate data functions are outsourced, new broadband infrastructure is rolled out, and consumers ramp up use of cloud computing, big data, and the internet of things.

Development risk is decreasing as the sector becomes established as an institutional asset class. In addition, its specialist nature is now seen as an asset because it keeps away the competition. According to one foreign opportunistic investor adopting a build-to-core strategy: "The biggest program we have going right now in China is data centers, where we've backed a group to roll it out. There are a lot of barriers to entry, which is one reason it's more difficult to execute, but that also keeps out a lot of competition, especially from local developers."

Investors identified Hong Kong, China, India, and Singapore as potential destinations, with projected internal rates of return (IRRs) of 13 to 15 percent. In particular, Singapore may move to encourage creation of data center facilities given its long-term policy to reinvent the city-state as a tech-oriented hub

and the gradual loss of its manufacturing industries to other Asian markets.

## Affordable Housing

Another alternative asset class beginning to gain traction is affordable housing. The market here is seen as a low-to-mid-income proposition because low margins available for poverty-level housing have no appeal to investment funds. The scope of opportunity is growing as prices of conventional residential properties across the Asia Pacific region move beyond the reach of working-class incomes, and as government policy initiatives begin to open up the market for large-scale construction.

Most recently, authorities in Hong Kong launched a series of measures aimed at jump-starting production of low-cost housing. According to one Hong Kong-based consultant: "There's going to be a shift in the power base, because hitherto developers have basically called the shots. They don't see their role as delivering any form of social housing, [so] you're now going

a selective basis, some are also looking at second-tier cities that have now worked through their supply gluts. Destinations in this category mentioned by China-based interviewees included Chengdu, Wuhan, Nanjing, and Hangzhou.

That said, the problems identified above appear to be more of a deterrent for opportunistic than for core capital. This is reflected in the fact that, despite rapidly rising prices, the value of deals involving foreign buyers in the first half of 2017—primarily big transactions in and around Shanghai, where more than 60 percent of foreign real estate investment in China takes place—has remained resilient at about a third of the roughly US\$13 billion deployed, according to JLL.

Why do foreigners continue to bid so aggressively? In part, because growing numbers of limited partners looking to allocate to China have placed capital in China-oriented funds, and managers are now deploying it. In addition, the overall shortfall of available assets across Asia means that core investors are now increasingly turning to China to place capital, at least partly on the basis that higher risk and cost of capital are offset by potential upside, quite often in the form of build-to-core development plays.

According to one fund manager: “Basically, you’re forced to say, okay, I’ll fund a development program so that I can get access to the stock and be in for the long term. I think to call it ‘core’ on that basis would be a stretch, but as a

firm we agree that manufacturing core income streams is a better place to be in the risk curve than buying them today.”

In doing so, investors are not only hitching their wagon to the train of apparently never-ending capital appreciation. They are also tapping the appetite of cash-rich Chinese insurance companies that are barred from participating in development but have enormous appetite for acquiring completed prime real estate. By some estimates, Chinese insurers are set to bring an additional US\$90 billion in new capital to China’s commercial real estate market by 2020.

For domestic investors, meanwhile, the playing field is uneven. With big institutional players competing intensely for the limited supply of prime assets in first-tier cities, other local investors—including a growing number of developers now branching into asset management as development margins decline—are looking to projects in outlying areas of big cities. They are also turning to second- and third-tier city projects, although these locations often have ongoing issues with poor liquidity and chronic oversupply. Increasingly tight financing conditions continue to drive consolidation within the industry as smaller players become acquisition targets. This is generally a play open only to larger domestic developers, although there may be scope for foreign investors to partner with a local operator.

to see a more proactive policy with developers told to provide, say, 35 percent of units in the form of affordable housing, as in London and New York.” Several developers in Hong Kong have seen the writing on the wall and are now offering up suitable sites for new projects. This model is also already in place in China and now appears likely to be implemented elsewhere in Asia.

In Indonesia, the government is on track to build some 900,000 affordable housing units (at average sales prices of around US\$33,000 each) in 2017, following completion of some 700,000 the previous year, mostly in low-density projects about 25 to 30 kilometers from city centers but near inbound rail lines. Subsidized deposits and/or financing are available. One local developer reported IRRs north of 20 percent with a two-times equity multiple, though these may not be universally available. According to an investor with a foreign fund: “Returns are very low—once you deal with a local partner they’re really in the mid-single digits, which is more Asian Development Bank than private equity returns.”

India is another market where government-backed programs envision the creation of millions of new units. Affordable housing projects were granted “infrastructure status” by the central government in early 2017, providing access to lower financing costs and tax exemptions, and boosting interest from institutional investors. The supply of newly constructed affordable homes in India increased 27 percent year-on-year in the first three quarters of the year to some 26,000 units, according to brokers Cushman & Wakefield.

Despite the advantage of growing government support, however, investors remain cautious about affordable housing as an asset class. One problem is that producing the vast numbers of new homes being talked about will require equally vast reserves of land on which to build—a resource that is either too hard to find, too expensive, or so far away from city centers that people don’t want to live there.

Another is that government participation can be as much of a hindrance as a help. One institutional fund manager commented he would prefer to see the sector stand on its own

## Japan: Key Themes

The aggressive program of quantitative easing introduced by the Japanese government in October 2012 proved to be the launch pad for a multiyear bull run in Japanese asset prices that has resulted in a long period of sustained growth in rents, capital values, and values of real estate investment trusts (J-REITs). With profits boosted both by cap rate compression and high levels of gearing provided by local banks, many local and foreign investors have made huge profits in the years since 2012. One core fund manager, for example, reported IRRs “north of 28 percent” for a recently divested office portfolio.

However, despite positive business sentiment, strong transaction volumes, and a relatively robust annualized 2.5 percent GDP growth in the second quarter of 2017, market momentum in Tokyo seems to have ebbed, with many interviewees expecting transactions to decline as J-REIT purchasing slows and funds take a more cautious view of the market.

There are at least a couple of reasons for this. First and foremost, with rental growth flatlining and office yields compressed to under 3 percent, many investors have concluded that the cycle of easy money is over. At the same time, in an environment where supply continues to tighten as both domestic capital and foreign capital compete for a shrinking pool of available assets, landlords have little incentive to lower prices. As one locally based investor commented: “There’s not a lot of stuff out there, and there’s no pressure from the banks or the government for anyone to sell. So, there’s now a growing bid/ask disparity, particularly for office, because a lot of sellers think there’s still going to be great rent growth even as buyers are now more conservative about that scenario.”

Problems in the office sector have been compounded by concerns of oversupply, with a big pipeline of new space set to arrive by 2020. Overall vacancies appear tight at under 4 percent, but in newly developed buildings they are running at almost 30 percent, according to estimates by Deutsche Asset Management, suggesting that in the absence of more meaningful economic growth, occupancy of older buildings will be at risk as tenants migrate to the new supply.

One result of diminishing return expectations is that investor attention is now shifting toward a focus on yield rather than growth. From this perspective, Japan is an attractive market for institutions to park funds because, at around 3 percent, the yield spread (i.e., between the yield on the asset and that of the Japanese sovereign bond) is probably the widest in Asia. As a manager at one institutional fund observed: “You get maybe a 4 percent rental or NOI [net operating income] yield and then on top of that you can borrow money today at less than 1 percent. So, you have this big margin, you’re not levered, and cash yield is around 7 percent to 8 percent—that’s very rare to find on a stabilized income profile anywhere in the world.”

What this means in practice is that many fund managers are also now shifting their focus in terms of asset class. According to one: “We’ve now moved away from office and have expanded our expertise to residential because we feel going forward that Japan will be a low-inflation, low-growth, and low-interest-rate environment, and as such we prefer to invest in an asset class with lower volatility.” While opinions vary over prospects for residential rental growth given a lack of wage inflation, competition in this space has seen residential transaction yields in Tokyo—which stood at around 6 percent only three years ago—decline “from

merits without the benefit of government subsidies before he would consider investing. Another India-based consultant feared how government red tape might affect profits: “The approval process is still not a single window and the challenge is that you are not necessarily playing on margins, you are playing on volumes. When you are delivering tens of thousands of homes every year, your entire value chain has to work in a well-oiled manner—you don’t have time for overruns that are beyond your control.”

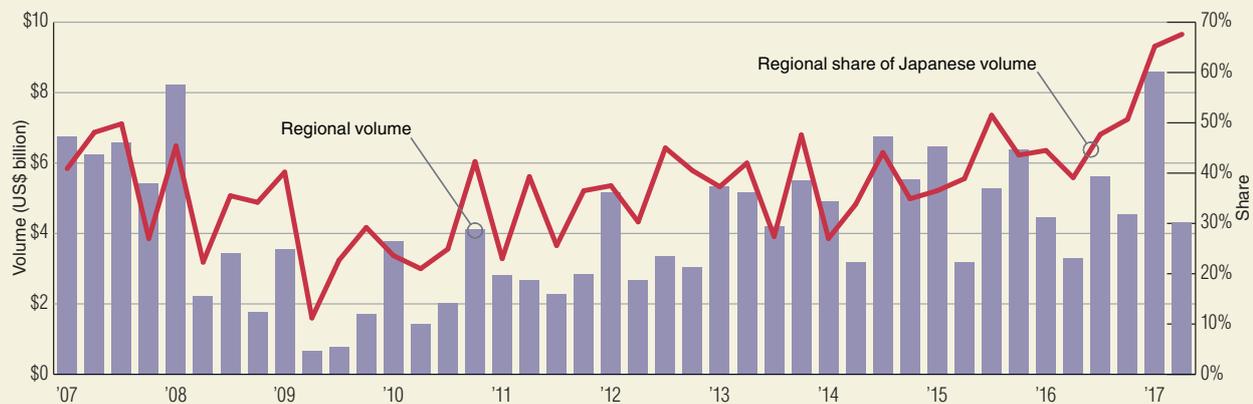
## Multifamily

With home prices across the region moving increasingly out of reach, the need for long-term rental housing stock is grow-

ing. This is a sector with obvious appeal for yield-oriented institutional investors both in Asia and globally, but because Asian markets (apart from Japan) have no history of build-to-rent as an asset class, investors are now casting around for a viable business model. As one fund manager said: “We put it in the same category as retirement housing—conceptually the demand is there, it makes sense, but we haven’t figured out how to make money doing it yet.”

In China, both foreign and domestic investors—including some of the country’s biggest developers—are actively working to establish operating platforms, mostly targeting a younger demographic of single or double occupancy. One foreign fund now active in this area has established

Exhibit 1-11 Volume Accelerates in Regional Japan



Source: Real Capital Analytics.

Note: Figures are for deals above US\$10 million, development site included.

high-3s into the 2s over the last six to nine months,” according to one interviewee active in the sector.

In addition, concerns about supply shortages also are emerging. According to one longstanding buyer of Tokyo residential: “Transactions are down. We’re now buying portfolios, but they’re smaller assets. We typically bought larger assets until about nine months ago, but either they’re no longer available, or when they are they’re priced higher because sellers know there aren’t a lot out there.”

Meanwhile, those more focused on higher yields are looking increasingly to secondary cities. The migration of funds out of Tokyo (in particular to Osaka and Fukuoka) picked up significantly in 2017, with Japan’s five major outlying destinations now accounting for more overall transaction volume than Tokyo, according to CBRE.

This has led to increased competition and rapid compression of yields, however, as capital values soar. At the

beginning of 2017, the yield gap between office assets in Tokyo and outlying cities was at least 100 basis points, according to RCA, but that differential is now shrinking, meaning the comparative advantage of secondary cities has diminished significantly.

On the residential side, according to one investor, positive supply/demand dynamics combined with a lower base mean rents have greater potential to rise in secondary cities. But as more funds shift their focus outside Tokyo, yields are compressing rapidly. According to one fund manager: “We started buying residential in Osaka about 18 to 20 months ago. We got some deals done, but people have been very aggressive and the market then moved so quickly—from a 5-cap to 4.5 to low-4s—that we started to get priced out. And when that happens, it’s not a good scenario because once you’re on that train chasing it down, at some point you’re buying based on Tokyo prices. So, Tokyo at 4.2 or Osaka at 4.2? It’s not a hard decision to make.”

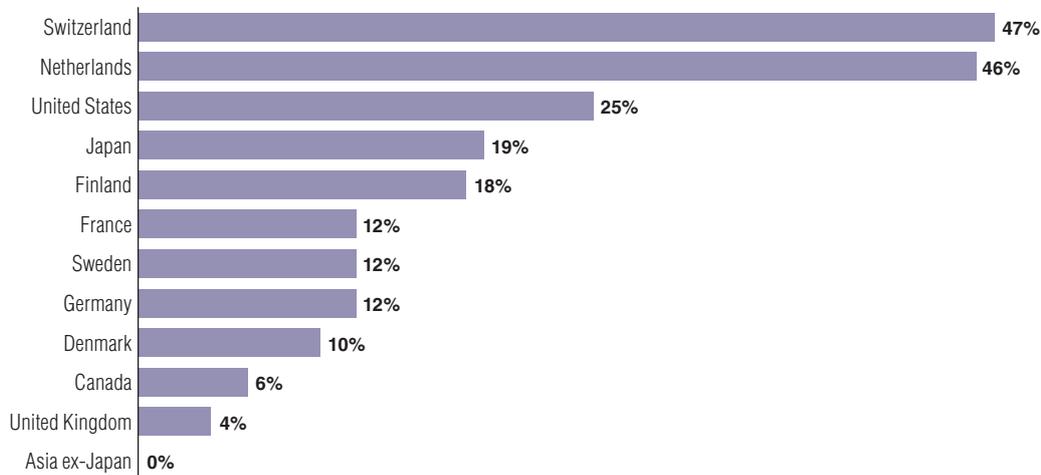
a Mainland platform based on a portfolio of older office buildings or retail podiums it master-leases for ten to 20 years. This offers a much cheaper approach than buying the underlying land. The buildings are then converted into studio apartments of about 22 to 25 square meters and sublet at US\$400 to US\$500 per month.

As a manager at the fund explained: “The demand is huge because the rental class in China is measured in the hundreds of millions, but I think the concept of what multifamily is and how it’s deployed will be very different from what it’s been in the U.S. and Japan. And it’s not easy—most real estate funds work building by building, but one of our platforms has close to 30,000 rooms spread across 250 sites. So, the bigger

focus is operational—creating a standardized model, being able to scale management teams. It may be easy for ten sites, but much harder for 100 to 200.”

High taxes, rental yields as low as some 2 percent, and the lack of any formal legal structure in China that caters to a build-to-rent model were cited as obstacles to more widespread adoption of multifamily projects by institutional investors. Nonetheless, momentum is gathering, in particular on the political front. Recent government-backed programs feature cut-price land parcels zoned for development as rental apartments, as well as allowing rezoning of commercial and rural land into for-rent residential purposes.

**Exhibit 1-12 Residential Assets as a Percentage of Institutional Real Estate Portfolios, 2015**



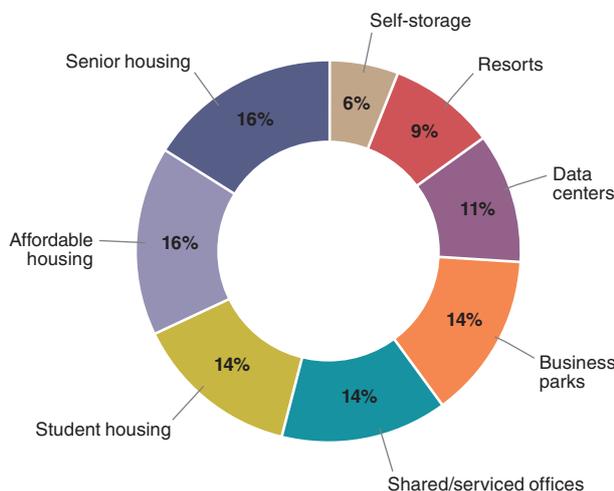
Sources: IPD, NCREIF, LaSalle Investment Management.

The Chinese government also seems intent on creating a financing framework that will allow developers to spin off low-yielding residential assets they are currently obliged by law to hold and manage as rental properties. In October 2017, Chinese regulators approved the issue of some US\$750 million in asset-backed securities (ABS) by a major domestic developer backed by rents from a portfolio of its rental apartments, with a coupon of 4.88 percent. While it remains unclear how the properties could justify such an apparently high yield, this is likely to be the precursor for many more such ABS issues, with authorities seemingly intent on using the ABS framework (and possibly also a REIT-based framework) to

promote the evolution of a nationwide institutional residential leasing platform. This would be the first listed implementation of a major ABS facility for Chinese real estate assets, and indeed the first significant move in Asia apart from an ill-fated Japanese excursion into mortgage-backed securities in the run-up to the global financial crisis.

The build-to-rent concept is also gaining ground in Hong Kong, where the world's highest home prices have consigned increasing numbers of young people to rental housing. One locally based value-add manager, describing his model as "student living for young professionals," outlined a strategy similar to that used in China, with super-small footprints of around 20 square meters complemented by shared communal and dining areas in city-center locations.

**Exhibit 1-13 Niche Sectors in Which Investors Are Now Active or Plan to Be Active**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

The main problem is that Hong Kong has very little en bloc stock available for conversion to multifamily use. "Even if you can find a whole en bloc residential building or at least the upper floors of a residential building, quite often you're competing with developers to buy it. Beyond that you've still got to pay stamp duty, which is 23.5 percent. So, it's quite challenging to find the raw product to do a multifamily strategy." As a result, some investors are now looking at purchasing hotels, especially pencil-building Grade-B boutique hotels that can be converted to a residential strategy.

Hong Kong's strata-title issue is echoed in other markets across the region, including Australia, where many institutional buyers are now looking to create build-to-rent strategies.

A further stumbling block is that returns for this emerging asset class strategies are usually inferior to those of a stan-

standard build-to-sell approach. According to a fund manager in Australia: “Multifamily is very much a focus at the moment, but the trouble is making it stack up, because from a developer’s perspective, the best return on investment is to strata-title the project and sell it. In fact, you can’t even get it financed until you’ve sold 60 percent or 70 percent off the plan. So it’s difficult to see how developers can buy land, build a big apartment building, and then sell it profitably to an institutional investor. The yield to the investor is about 3 percent gross—it simply can’t compete with 4.5 percent to 6.5 percent from retail and industrial assets.”

Australia’s low-yield problem is shared by China, where rental yields on residential properties are currently as low as 2 percent—significantly below those for build-to-sell development. The same does not apply in Japan, however, due to the low interest rates charged by Japanese banks. As one interviewee commented: “When I look at risk/return, Japan still stands out compared to Australia, where the yield is comparable to the borrowing cost of 3.5 percent to 4 percent. So, the margin isn’t good enough, or at least not comparable to something in Japan, where margin arbitrage is significantly higher than probably anywhere else in the world.”

### Student Housing

Another niche area where Asia Pacific investors have been active for some time is student housing. The focus regionally continues to be on Australia, where international student numbers are booming and inner-city student housing has been an institutional asset class for several years.

However, while relatively few stabilized assets have so far traded in this sector, the problem is that yields have already been bid down to what seem very compressed levels. According to one fund manager: “Like everything else, student housing yields are getting really competitive. I’ve had three or four people who have come to me wanting to build portfolios of student dorms in Australia, and they’re building to single-digit development yields, which is historically very low for all the risk you’re taking. So, if you put a 10 percent contingency on your cost, and you’re underwriting a yield that is less than 10 percent, then, if your contingency goes, so does your yield.”

**Exhibit 1-14 Forecast Yields for Australian Student Housing**

Location	Yield range
Melbourne	5.50%–6.25%
Sydney	5.50%–6.25%
Brisbane	6.75%–7.25%
Adelaide	6.75%–7.25%
Perth	7.00%–7.50%

Source: JLL.

Investment activity in education-led real estate elsewhere in Asia has historically been quite weak, but it has recently picked up in Far East markets such as Hong Kong, South Korea, and Japan. One investor spoke of investments in tutoring schools in Hong Kong and Seoul whereby the real estate is leased to an established tutoring operator.

### Senior Housing

For years, investors have been hunting for a senior housing strategy that will work in the Asian context, given the region’s aging demographic and the fact that so many younger people now have full-time jobs that prevent them looking after aging relatives. While the search for a business model continues, it is probably fair to say that institutions are now closer to finding a solution for the simple reason that rapid economic and property price growth has left older generations in Asia far better off—in terms of both liquid and property-based assets—than they were in the past.

Australia, as the most Westernized market in the region, has made the most progress toward a workable formula. According to one Singapore-based fund manager, the optimal profile is a somewhat younger, healthier demographic that can be housed in an independent living facility, for which he assessed an annual demand in Australia of around 28,000 units, compared with current supply of around 8,000 units, mostly of poor quality: “The opportunity is to build apartment-style upscale accommodation for seniors who are generally asset-rich but cash-poor, who can sell down their house, live within their existing catchment, and be connected to family and friends,” he said. In addition, the fund was targeting aged-care facilities (i.e., nursing homes) as part of a core investment strategy. This would be structured on a leasehold basis in partnership with an established operator in order to avoid operating risk.

Investors elsewhere in the Asia Pacific are looking to adopt similar models, leveraging the growing spending power of an increasingly well-off demographic. So far, however, they have yet to find the right formula. According to one interviewee: “We’ve looked at this sector heavily and as a firm we’ve invested quite a bit. But the reality in China is that no one has the model. Is it a for-sale model or membership model or monthly rental model? So they’re still grappling with the mode of delivery. And to that point, I don’t think there is one operator in the country that has profitable sites.”

In Japan, the details differ, but the outcome is much the same, despite a generally wealthier population. According to one Tokyo-based investor: “The operators are the issue here because senior housing in Japan has historically been built for inheritance tax-avoidance purposes. Each senior housing unit in Japan is pretty small, maybe 40 or 50 units per building, and is run by mom-and-pop operators. It’s very difficult

for institutional investors to invest in such small facilities, especially when operators are not so mature.”

## The Coworking Juggernaut

Few trends within the commercial real estate world have taken off as quickly as coworking. Only 24 months ago, most people in the industry had never heard of it. Today, it is taking the office sector by storm, with coworking operators the biggest source of demand for new office space in many major cities both in Asia and throughout the world.

Although the implications for landlords and investors are huge, the fact that the trend is occupier-led means many landlords have been slow to embrace change. According to one analyst: “These days, investors are increasingly coming to us not to ask about yield or rents, they want to know about buildings’ occupiers—who are they, what are they thinking, and what are their space requirements?” This is because some investors, especially those from core funds, prefer to avoid tenants from industries that may be prone to disruption. “They know tech disruption is happening from coworking and also in the financial industry, where there have been a lot of layoffs because of fintech [financial technology]. So, they may not want a big concentration of bank and tech companies in their properties. The way they see it, one minute they sign a three-year lease, then the cycle passes, the company goes bust, and they’ve lost two floors. At least if they have more law firms, which use traditional layouts with cubicles, they think the demand will be there.”

This logic is questionable, however, firstly because ongoing changes to office use and configuration are probably permanent, and secondly because tech continues to grow as a component of tenant bases across the region. Currently accounting for around 17 percent of Asian Grade-A space,

according to JLL, tech firms are muscling into CBDs that have long been dominated by traditional tenants in order to attract talented staff and as workforces of banks and other conventional tenants are hollowed out by advances in fintech and artificial intelligence.

Other issues also point to rising demand for modernized workspaces:

- Open-plan layouts use space more efficiently, thereby cutting costs.
- Evolving workplace technology and greater use of outsourced labor create uncertainties about staffing needs that in turn generate demand for flexible workspaces to absorb worker spillover, either temporarily or permanently.
- Finally, according to another analyst, early adopters of modern layouts benefit from an intangible sense that “they add to the style and feel of the building, generating brand building—both online and the physical brand inside. And if that helps to attract millennial talent, it’s something occupiers and investors want.”

Most interviewees agreed that embracing the future now is preferable. As one said: “We’ve never seen change at the speed we’re seeing now. So how do you respond to that, or how at least do you allow yourself the margin to be able to respond? It’s as if ultimate flexibility, whether it’s physical or financial, is the overriding theme.”

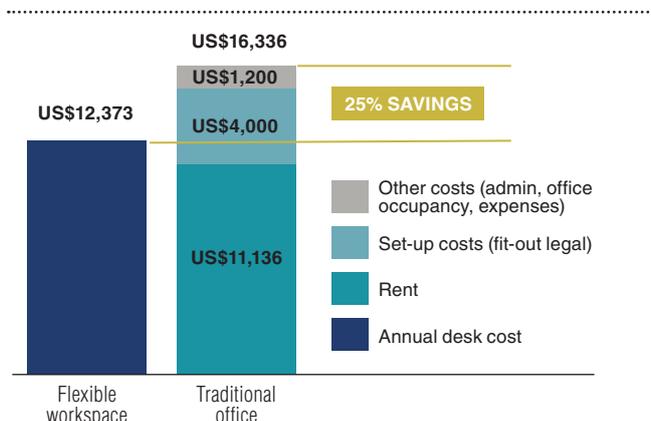
## Demand/Supply Imbalance

There is no doubt that the speed of ongoing change in the office space creates significant risk. The major questions are: how to strike a balance between unconventional and traditional use, and how to create leasing structures that work for everyone?

As to the first issue, oversupply problems for coworking operators may well be looming given that the sector’s explosive growth has obscured the true extent of user demand, for both operators and users. As one fund manager somewhat cynically observed: “I see coworking spaces as little more than a purgatory for staff because eventually I have a feeling they’re all going to be let go anyway, and everyone will just be chasing around for whatever contract they can get from their previous employers.”

The supply/demand issue also leads to a risk/reward question: should landlords move now to adopt operating risk? The traditional mentality, as one fund manager put it, is that “they’re paying us a rent, and any profit they get from their tenants over and above that is their own business.” But while landlords are generally reluctant to accept the industry’s short

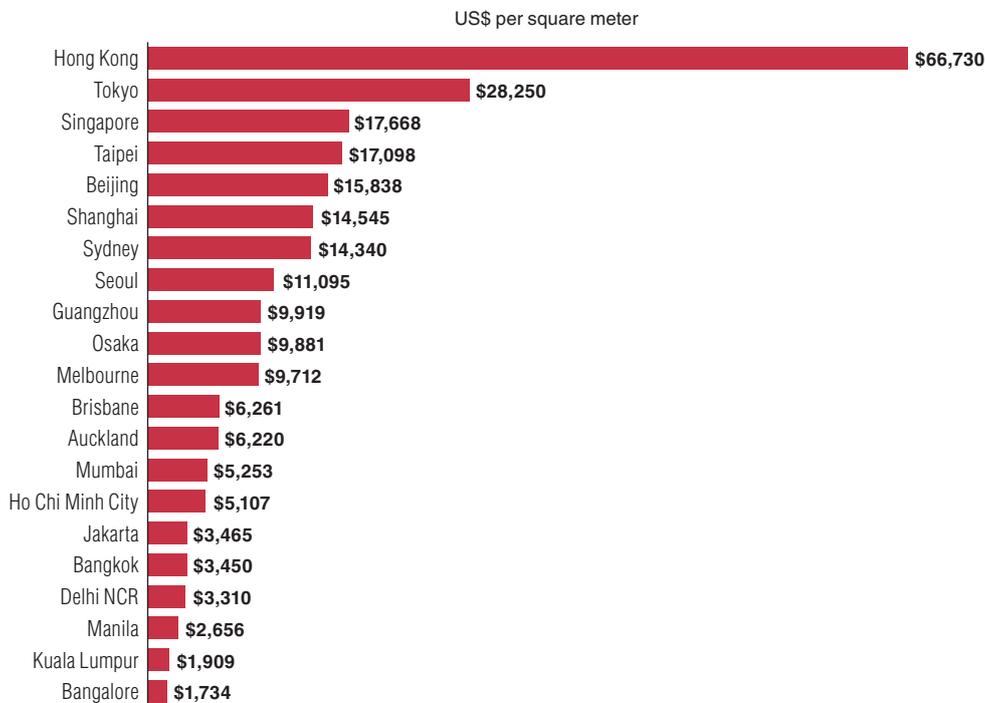
**Exhibit 1-15 Coworking Cost Savings Based on a Hong Kong Example**



Source: Colliers.

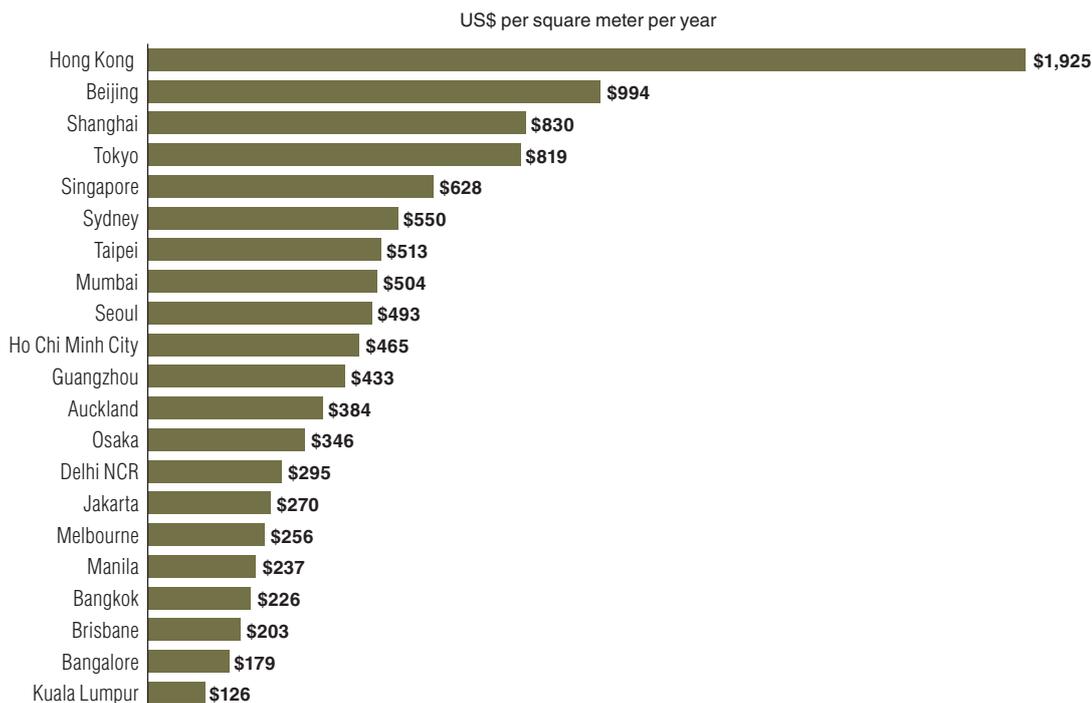
Note: Based on 120 square feet per person, three-year traditional office lease, HK\$60 per square foot per month (US\$93 per square foot per annum).

Exhibit 1-16 Asia Pacific Office Capital Values, Second Quarter 2017



Source: JLL (Real Estate Intelligence Services).

Exhibit 1-17 Asia Pacific Grade-A Net Effective Rents, Second Quarter 2017



Source: JLL (Real Estate Intelligence Services).

## Australia: Key Themes

Markets in Australia are some of the few in the Asia Pacific to have bucked the trend of slowing rental growth, with effective rents for Sydney prime offices rising an annualized 25 percent (Melbourne 16 percent) in the second quarter of 2017, according to JLL. Strong fundamentals in both cities have been boosted by declining incentives, limited incoming supply, and the withdrawal of significant numbers of CBD buildings from the market.

Going forward, positive supply/demand dynamics should help maintain pressure on yields, which have moved to sub-5 percent in both Sydney and Melbourne. Although cap rates are now below 2007 lows, asset pricing in general is not that high by Asian standards, leading to expectations of healthy IRRs if—as expected—rents and capital values continue rise. According to one investor: “Sydney is crazy. I can see it being a long cycle because there is no release valve—nothing is being created, and anything that is [created] will be ages away.”

Given also the high yield spread to sovereign bonds, Australia remains a firm favorite among foreign investors (accounting today for more than 40 percent of domestic investment activity), with Sydney and Melbourne topping this year’s Investment Prospect Rankings. According to one Singapore-based manager: “Borrowing costs in Australia are a bit higher, but it still looks interesting if you’re looking for strong cash-on-cash returns because it’s probably the only market in Asia where you can not only buy assets with very long leases, but also underwrite annual escalation of between 3 and 4 percent.”

leases and proposed profit-share arrangements—with an eye, no doubt, to the reality that many operators are losing money—they must also calculate if they really want to cede the initiative to operators just as such a major evolution of workplace use is being rolled out, especially when coworking providers have already been such huge disruptors in the office space.

The alternative would be for landlords to create dedicated coworking spaces in their buildings for lease to tenants or anyone else. According to one analyst: “Most tenants would probably prefer landlords to provide whole floors as coworking spaces because it gives them flexibility—they know that if they run out of space [in their own offices], they can just then go there to work. It’s a value-add proposition for tenants, and I think it’s a better solution for landlords than leasing out spaces to coworking companies. But at the moment, investors are just not thinking ahead.”

As ever, however, the big problem is actually finding properties to buy. Transactions in the first half of 2017 were down 37 percent on previous-year figures, according to CBRE, mainly because owners are reluctant to sell when there is little else to buy if they do. About one-third of activity came from foreign funds, slightly down on previous years.

Meanwhile, investors are adopting a number of strategies to get capital into the market, including build-to-core and forward-funding strategies. An upcoming problem, however, is that development opportunities in Sydney and Melbourne CBDs are likely to dry up. As one Sydney-based fund manager observed: “I think historically the challenge has been putting sites together. A lot of the smaller buildings in the CBD have been strata-titled, which makes it hard to consolidate sites to provide somewhere with a floor plate big enough to be attractive to tenants. So at the moment, we can’t see any more sites available where you can actually undertake this type of lifestyle redevelopment—the ones we are seeing at the moment are pretty much it.”

With more buyers than sellers in CBDs, many investors (including foreigners) are now willing to move out from the center. Parramatta, for example, a suburb located 23 kilometers west of the Sydney CBD, was described by one locally based fund manager as a “future alternative CBD in Sydney.” Another described it as a “great market with cheap rents and strong near-term rental growth.” The rise of this type of outlying business district is expected to

## Vietnam and India Rank as Most Popular Developing Markets

Developing markets continue to draw interest. In previous reports, a succession of emerging-market cities—in particular Bangalore, Jakarta, and Manila—occupied top positions in our investment prospect rankings. This year, only one—Ho Chi Minh City—stood out, as sentiment elsewhere declined.

In particular, **Indonesia** continues to suffer the effects of an office supply glut. Still, prospects in Jakarta are not universally negative. According to one locally based developer, new premium office projects have no problem finding tenants as long as they are centrally located and near light-rail transit (LRT) lines. Rents are down, but these properties will be well positioned once the market turns. The same applies on the residential side.

continue as city centers fill up and infrastructure—especially transportation networks—improves, given especially the large deal sizes on offer.

After years in the doldrums, activity is now also picking up in Australian secondary cities, where fundamentals have begun to turn. Brisbane (together with areas along the Gold Coast) has probably the best prospects, with projected 16 percent effective rental growth for 2017–2018, according to CBRE. At the other end, rents may have bottomed in Perth, but investment activity remains very limited.

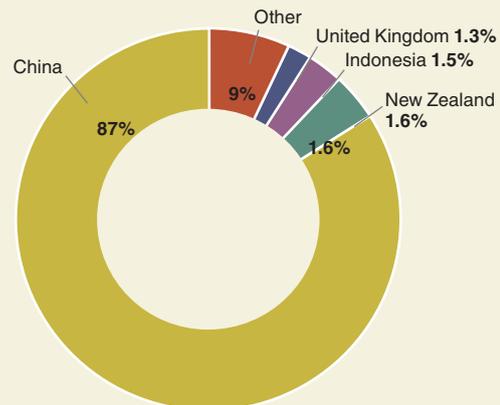
Alternative asset classes are another area seeing significant investor interest, once again in line with other regional markets. In particular, student housing has become firmly established as an institutional asset class in Australia, while senior housing seems finally to be gaining critical mass. Both were repeatedly mentioned as potential investment targets in interviews.

In addition, logistics assets remain a draw for both local and foreign players. Fundamentals remain strong and transactions (including portfolio sales) have continued to track at high levels, drawn by yields that are compressing but still average around 6.5 percent, according to JLL. According to one foreign investor: “It ticks the boxes for the institutional investor mainly because of the freehold nature of the property. At the industrial end [in Singapore], we tend to get short leaseholds, so that’s what’s driving it. But on top of that, [in Australia] we get longer commitments from tenants and step-ups in the rentals, which is a standard operating procedure. Add in the government

and the transparency and it’s far better than the other countries we have to choose from right now.”

In the residential sector, prices continue to rise despite government efforts to stem the tide. Sydney’s housing is now the second most expensive in the world, registering 12.2 times average incomes (9.5 times average incomes in Melbourne), according to analysts Demographia. Various regulatory measures have been adopted, including punitive taxes on foreign buyers, who now represent some 25 percent of all home purchases in New South Wales, according to Credit Suisse. The measures have done little to blunt rising values, however. Interviewees expected that prices would continue to rise.

**Exhibit 1-18 Foreign Purchases of Australian Residential Property, First Half 2017**



Sources: New South Wales Office of State Revenue, Credit Suisse.

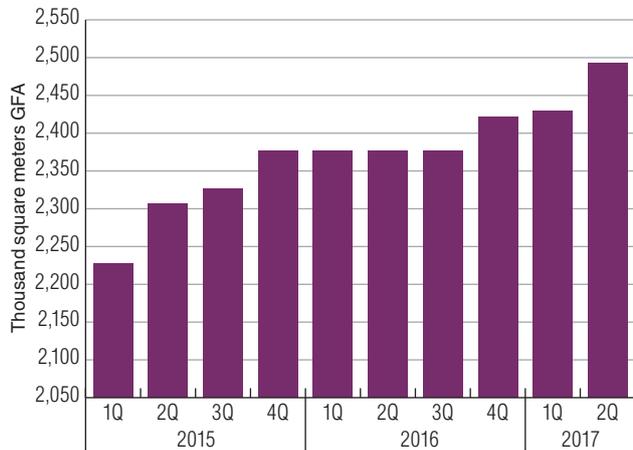
**The Philippines**, meanwhile, remains a healthy market, with both rents and capital values continuing to trend upward amid an infrastructure boom and economic growth of some 6.5 percent. However, concerns over U.S. base rate increases, together with domestic political issues have been a drag on sentiment among foreign investors, as have longstanding difficulties in finding good local partners with whom to work.

In **Vietnam**, investors continue to draw favorable comparisons with the China of ten to 15 years ago. GDP growth is in the area of 7.4 percent, and while bureaucracy remains an issue, the regulatory environment is becoming slowly less restrictive. Notably, our survey ranked Ho Chi Minh City among the highest in terms of rental value growth, reflecting confidence that economic strength will spill over to property values. Unsurprisingly, Vietnam remains very much a development story, although the number and size of opportunities tend to be relatively small.

Very little prime office stock has been built in recent years, meaning very few stabilized assets are available to buy. That leaves the residential sector as the default play for most investors, usually in conjunction with a local joint venture partner. According to one fund manager: “There’s been a general recovery economically, but asset levels have not lifted to pre-global financial crisis levels as in other markets. So we see strong growth prospects from a macro perspective. Our entry point there is mid-to-affordable residential housing, which has a natural exit. It’s very demand based. That’s a strategy we’re executing on now.”

The other developing-market story now proving a draw for international investors is **India**. While Indian cities did not feature prominently in this year’s investment prospect rankings, probably because of ongoing qualms over operational difficulties, strong flows of institutional and sovereign wealth-type capital have continued. Like Vietnam, investment in India

**Exhibit 1-19 Ho Chi Minh City Total Grade-A Office Supply**



Source: CBRE.

tends to be strategic in nature, aimed at front-running long-term economic growth resulting from reforms being rolled out by a popular government intent on tackling India's enduring inefficiencies. Unlike Vietnam, however, India offers massive scale, a factor that makes it especially popular for funds deploying large amounts of capital.

Incoming flows have so far been dominated by the big players, but smaller funds are now also lining up. As one fund manager observed: "There's a real gap between the large LPs [limited partners] who are comfortable going alone, and the LPs who have traditionally backed funds—it's probably the market where we see the biggest gap between registering interest and actually doing something. So there's a significant amount of tire-kicking going on."

Most international investors in India continue to prefer commercial property, with cap rates currently averaging in the range of 8.5 to 8.75 percent. Over the last few years, various large global opportunistic and institutional funds have made big commitments to the Indian office sector—mainly in the form of business parks, and many of these early entrants are now either consolidating their holdings or looking to exit via India's nascent real estate investment trust (REIT) market, which is likely to see its first initial public offering (IPO) in the first quarter of 2018, according to several interviewees. With most high-quality preexisting assets already accounted for, international funds are turning increasingly to build-to-core projects. One recent strategy is to tap land banks of local corporate owners in tripartite joint venture arrangements with domestic developers.

India's logistics sector has recently been the target of an investment boom, largely due to tax reforms. In addition, retail assets also are now a popular play, with a number of platform or portfolio deals either already completed or in the works. According to one Delhi-based consultant, this is not only because office assets have already absorbed so much capital, but also because retail is starting from a lower base in terms of both asset quality and rental levels, providing investors better growth prospects: "In most of the retail malls countrywide, the average appreciation in rentals has been anything between 8 percent and 10 percent per annum, as compared to the office space, where rents have been more or less steady, growing at 5 percent to 7 percent per annum."

The residential space, meanwhile, continues to suffer from a developer base regarded as both financially weak and generally unreliable—issues that in the short term have been exacerbated by a raft of recent government reforms that include a demonetization campaign aiming to eliminate "black" (i.e., under the table) money, a new services tax, and increased regulation of real estate development practices.

According to one investor: "All these things have created short-term sentiment issues, but now, I think, and certainly in the more affordable workforce housing space, we're seeing sales in our projects pick up quite nicely, so it does look like it's working. At the higher end, though, it's still very slow."

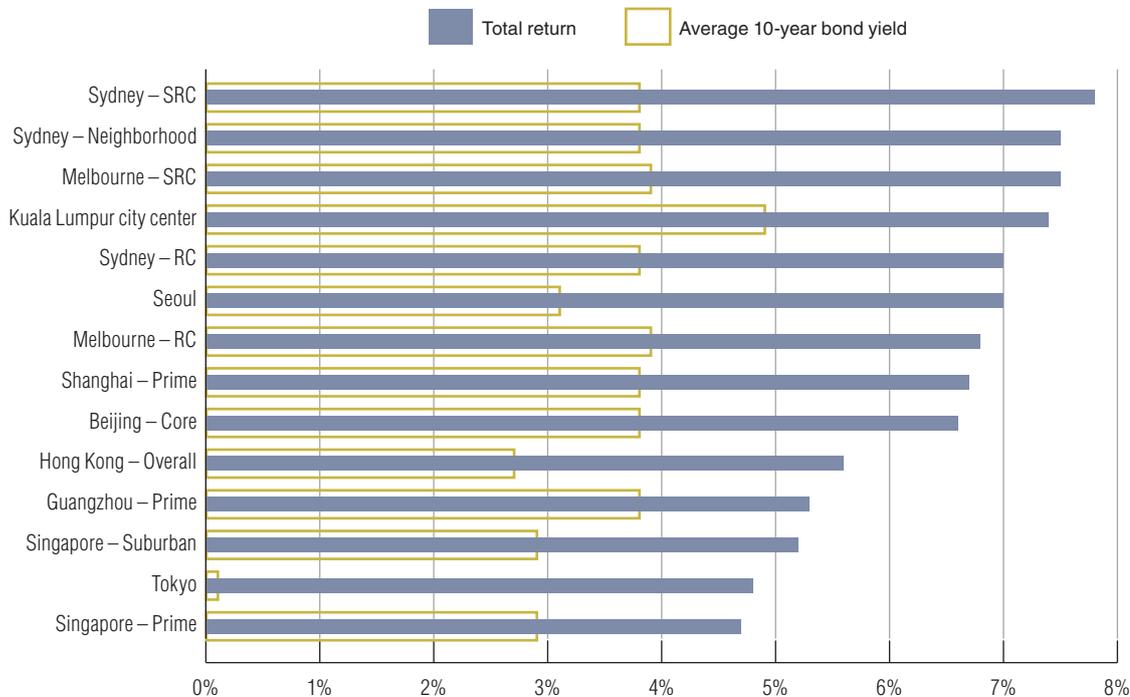
High-end residential oversupply is another ongoing problem, leading most foreign investors to shy away from the sector altogether. As one fund manager said: "I think you need to more intimately understand the market to do residential in India. The bigger guys doing direct joint ventures seem to have had more traction on the office side—it's just easier to get scale." And, according to one locally based interviewee: "Residential today is no longer a core focus area for any of the foreign investors. So the money continues to flow in, but a lot of the foreign guys are looking at office space development, trying ideally to forge preferred relationships with Indian developers to create platforms."

### Investors Still Bullish on Retail . . .

The downfall of so many shopping malls in U.S. markets provides a sobering vision of what might happen in Asia should competition from e-commerce continue to eat away at market shares of regional shopping centers. Perhaps surprisingly, though, opinions on the prospects for retail in Asia were quite polarized.

On the one hand, many interviewees remained sanguine about the ability of conventional retail to fend off online

Exhibit 1-20 Retail Assets, Projected Compounded Annual Return, 2017–2022



Sources: Oxford Economics, Deutsche Asset Management, as of January 2017.

Notes: RC = regional center; SRC = subregional center. Spread over sovereign bond is determined by projected income return plus capital appreciation.

challengers, pointing out that industry fundamentals remain generally strong, with rents and capital values trending either flat or upward across the region, and with analysts expecting healthy returns going forward. Poorly performing markets like Hong Kong and Singapore, meanwhile, are more a reflection of lower inbound tourism than a marked shift to e-commerce.

One reason for the optimism is that the retail industry in many parts of Asia remains immature: “It’s like a teenager,” said one retail developer: “Growing fast, changing fast, and quite unsure of what to do.” This means there are inefficiencies in the way Asian malls are built and operated that create potential for savvy operators to differentiate their own products.

Another reason is that shopping centers in Asia do not generally use the department store anchor model that has been the downfall of so many malls in the United States. Offerings tend to be fresher. Beyond that, many big facilities are being re-invented in an effort to protect themselves from e-commerce challenges. “We just did a big renovation in a shopping mall we own in Singapore,” continued the fund manager. “About 30 percent of that was already supermarket, and then we boosted the percentage of food and beverage, which is pretty immune to e-commerce, from 20 percent to 30 percent of floor space. So that’s what you want to have—services that

people can’t get online.” While these types of tenants generally pay lower rents than fashion outlets, the hit to the bottom line seems acceptable to most landlords.

A further point of differentiation is that investors in Asia have more options in finding assets that are less affected by e-commerce competition, in particular neighborhood or regional facilities. This is partly because this type of asset carries a higher proportion of nondiscretionary items consumers don’t buy on the internet. In addition, the resilience of neighborhood centers is a byproduct of Asia’s high rates of urbanization, with cities continuing to expand outward as migrants are drawn to urban areas. In China, for example, some cities are expanding so quickly that entirely new townships are springing up in city suburbs, providing captive consumer audiences that require their own dedicated shopping facilities.

Neighborhood malls are also seen as a haven in Australia, though for different reasons. The recent arrival in the country of e-tailer Amazon will likely jump-start a long-term boom in online shopping, but big distances between warehouses and customers based outside major cities mean that e-commerce deliveries will be both slow and expensive, slowing growth. While some interviewees did voice doubts about the future of large malls in Australia, this was more because they consid-

ered many shopping centers to be conceptually dated and slow to adapt to changes now being demanded by evolving consumer preferences than any challenge from e-tailers.

A final trend that should serve to boost neighborhood shopping centers is the rise of telecommuting, which relieves increasing numbers of office workers of the need to commute daily to work. As one investor commented: “People are becoming more local. So the whole concept of the CBD, where everyone drives in or transits to work is changing. With IT you don’t need to do that anymore. People still need to work with other people, but there’s no reason why that shouldn’t be distributed more. So what they call regional malls in Singapore are trading now at the same rents as those on Orchard Road. They’re not secondary assets anymore, they’re equally as good because people are going there instead.”

### ... But Others See Problems for Malls

Other investors, however, were less convinced that Asian retail will be able to shelter from the storm. According to one Hong Kong-based consultant, the challenge from e-commerce over the long term is probably being underestimated, and simple changes to tenant mixes are unlikely to be enough: “A lot of retailers are in denial,” he said. “The challenge is partly from e-commerce, but it’s also a question of customers’ expectations. They’re not looking for traditional retailing any longer, they want something more exciting and interesting and innovative, using up-to-date experimental technologies.”

Some operators are more open to change on this front than others. In China, for example, one experienced mall developer is creating innovative platforms that bring fundamental changes to mall operating models. These include a potential change in the traditional landlord/tenant relationship to one run on a partnership basis, with risks and returns shared. Another involves an “offline and online” concept that allows

e-commerce operators to set up physical outlets in strategic malls, while simultaneously helping mall tenants go online.

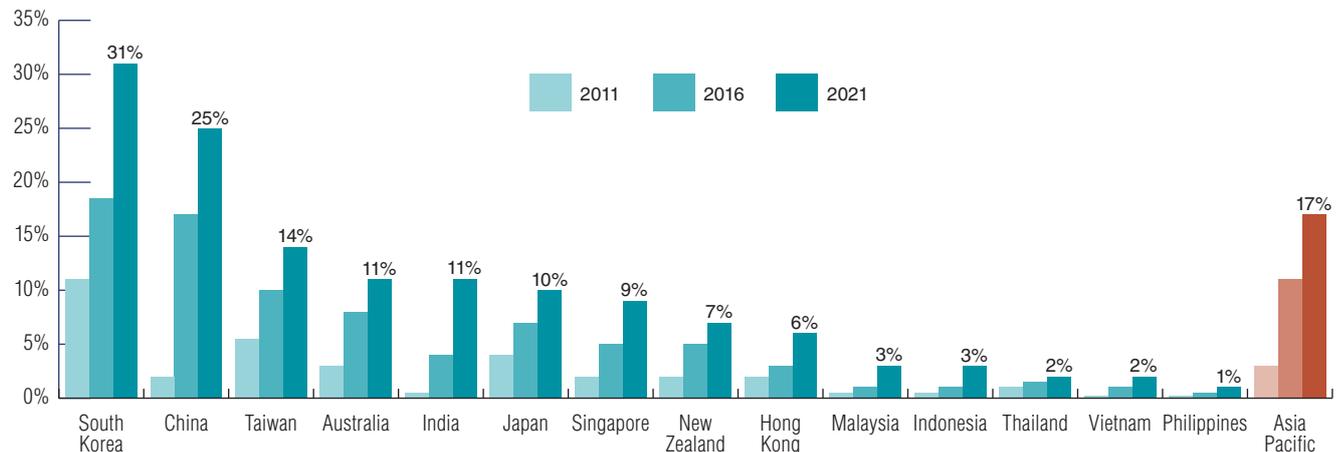
Finally, there is the creation of fulfillment centers within shopping centers that consist of reception areas, fitting rooms, and goods receiving and return areas, together with warehouse and car parking facilities. This model may also have wider application as a way for underperforming malls to convert unoccupied space to warehousing facilities to be used for last-mile delivery purposes. While it necessarily implies a reduction in rents, it does at least result in a functioning facility.

According to one Singapore-based fund manager active in the logistics sector: “The in-the-city, in-the-mall pickup places are going to come to the fore because e-tailers are going to have to start charging for delivery. Right now, no one is making money—the last mile is so expensive they’re finding it more cost-effective to negotiate with landlords of high-priced properties that are having challenges on rentals, get them down, and then use the deep spaces they can’t lease for distribution purposes. But it depends on the mall, of course; it’s not happening on Orchard Road.”

### Residential Markets Shrug Off Cooling Measures

Governments across the region have been trying for years to slow the steady rise of residential property prices, usually by imposing a regime of punitive sales taxes and higher mortgage downpayments. On the whole, however, their efforts have failed, with prices in most markets continuing to grind upward. One reason for this is the fear factor: many locals have concluded that prices will move completely out of reach if they don’t jump in, preventing them ever buying a home.

Exhibit 1-21 Projected Internet Retailing as a Percentage of Total Retail Value, 2021



Source: Euromonitor International, April 2017.

**Exhibit 1-22 Major Housing Markets Ranked by Affordability**

Source: Demographia, *13th Annual Demographia International Housing Affordability Survey: 2017*.

Note: Median multiple is the median house price divided by the median household income. Data are for the third quarter of 2016.

The fundamental catalyst for this process, of course, has been almost ten years of low interest rates, although supply shortages and strong demand from foreign homebuyers have also been factors in some markets. Over the long term, pressure for further price increases seems likely to continue given that developers are often paying sharply higher prices for new plots of land. As a result, home footprints are shrinking throughout the region and particularly in markets with the highest prices. In Hong Kong, for example, some 30 percent of new apartments approved for construction during the first five months of the year were smaller than 200 square feet, according to government figures.

Australia's high levels of immigration, in tandem with housing shortages and ever-growing competition from cash-rich foreigners, have prompted the country's three largest states to impose progressively higher taxes on foreign buyers (now equivalent to 9.1 percent of purchase prices in Sydney and 13.8 percent in Melbourne). Major banks have also introduced lower loan-to-value ratios on mortgages and are currently refusing to lend at all to foreign buyers. Development funding for residential projects has also been restricted.

While Australian residential prices appear to have plateaued in the second half of 2017, the number of foreign purchasers has only increased, suggesting they will serve to cushion upcoming price declines even if the market is now reaching a cyclical peak. According to one interviewee, Chinese buyers

are not deterred by either rising prices or current high taxes: "I think it's just not an issue for them because, quite apart from the fact that many people are just desperate for a foreign residence, property in big cities like Beijing and Shanghai is already more expensive than here, and incomes in China are rising faster than both Aussie taxes and housing prices."

The upward trajectory of house prices is similar in other markets, despite even stiffer restrictions and higher taxes. China imposes numerous potential duties on property sales depending on location and other criteria, while downpayments there are now a minimum 20 percent and as much as 60 percent for second purchasers in big cities. Average home prices in China rose 8.3 percent in the year to August 2017, according to official figures.

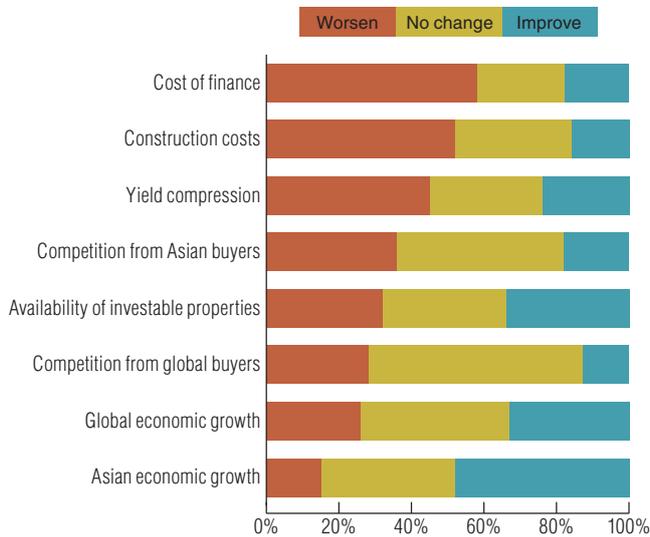
Home prices in Hong Kong, meanwhile, rose an annualized 10 percent on record transaction volumes in the third quarter of 2017, according to broker Midland Realty, despite prohibitive sales taxes on what is already the most expensive property in the world. Current duties increase buying prices by 30 percent for overseas purchasers, while downpayments are a minimum of 40 percent for most properties. Arguably the main reason for high prices is a chronic shortage of new housing stock, but another factor is that developers are now offering their own mortgage financing to bridge the gap between what banks will offer and what buyers can afford. In effect, therefore, 90 percent-plus financing is available in Hong Kong, but only for mortgages of new properties, thereby generating upward pressure on home prices because annual demand is much higher than the number of newly built homes.

Singapore has been the only market in Asia in which government efforts to contain price rises have actually been successful. Property taxes introduced in 2010 led to a market downturn beginning in 2013 that is only now showing signs of reversing, following the easing of some government tariffs early in 2017. That said, the peak-to-trough adjustment for mass-market housing has been only about 11 percent—a fairly modest decline. Notably, the main difference between Singapore and elsewhere in Asia is the government's tighter control over the land sales process, serving to underscore the role that supply/demand imbalances are playing in residential pricing dynamics. Since this seems an intractable issue in most jurisdictions, upward pricing pressures are likely to persist for the foreseeable future.

## Risk Fatigue

Almost ten years after the global financial crisis, the steady drumbeat of economic concerns that have informed global investment decisions—ranging from the consequences of zero-interest sovereign debt to ever-growing black holes on government balance sheets—appear finally to have faded. While the problems themselves remain as deep-rooted as

**Exhibit 1-23 Projected Change in Economic Factors, Next 3–5 Years**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

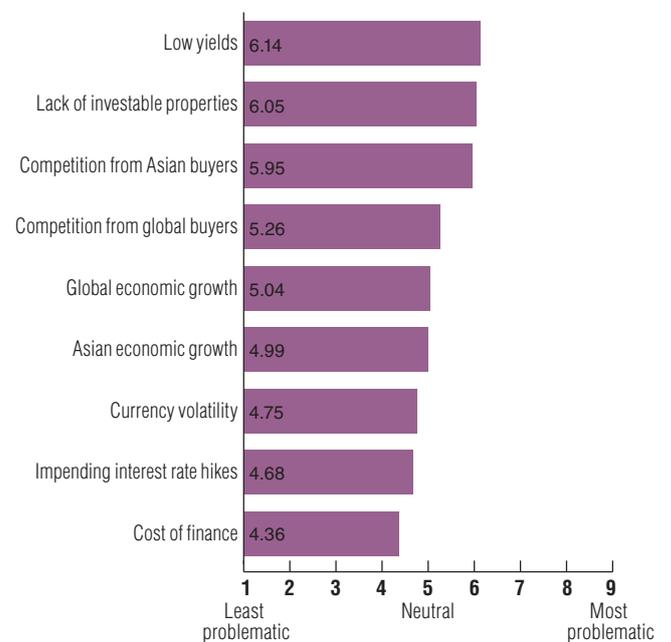
ever, investors now seem more inclined to embrace the reality that local property markets have delivered some of their best returns ever rather than to question whether economic conditions are really strong enough to justify them. As one fund manager in Australia put it: “I’m done being worried about the macro.”

That said, a number of background risks are worth noting.

The first, of course, is the continuation of those same macroeconomic issues that investors have now relegated to the back burner. Looking regionally, the Japanese economy and stock markets may be performing better than they have for years, but outperformance is predicated on policies that involve buying vast amounts of the government’s own debt, together with shares of locally traded REITs and exchange-traded funds (ETFs). The overleveraged Chinese economy is another well-established wall of worry that has now been compounded by the potential for trade-related disputes with an antiglobalist White House. In truth, however, these issues remain sideshows for most investors. While there is a significant body of negative opinion ranged against both Japan and China, the concerns are mainly focused on returns and operational issues rather than economic concerns.

While the potential for a further significant rise in U.S. base rates has obvious negative implications for real estate yields, interviewees remained reasonably positive about interest rate prospects over the medium term, with a “lower for longer” scenario deemed most likely. Cost of finance was ranked as the least worrisome of a range of potential problems in this year’s survey.

**Exhibit 1-24 Most Problematic Issues for Real Estate Investors**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

Geopolitical concerns, however, are now more front-and-center. In particular, prospects for conflict between the United States and North Korea have led to concerns of slowing capital flows to Seoul just as momentum had picked up among foreign investors. This probably accounts for Seoul’s low placing in our investment prospects rankings. While most interviewees said their own investment plans had not been affected, one or two indicated that deals had been pulled, at least temporarily. According to a manager at a large core fund: “We’ve definitely put a couple of deals on the back burner—deals we think we will still do but that we don’t want to close before we finish raising the fund. We just don’t want to run the risk that people who are about to go to investment committees for approval have to say: ‘And then they have these deals in Korea. . . .’”

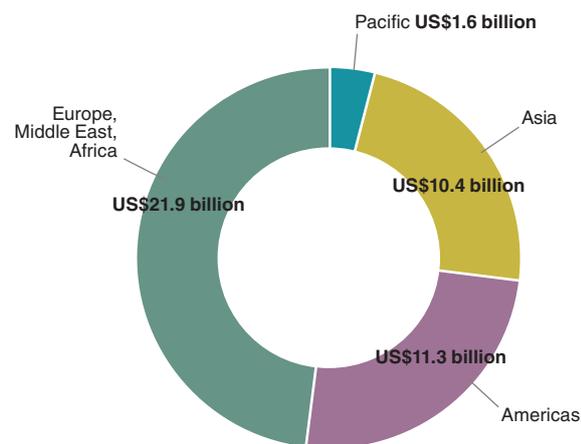
# Real Estate Capital Flows

“Flows coming out of China are slowing, but looking forward, portfolio deals will still get done—it’s the **individual transactions** that will have a much tougher time.”

The unprecedented growth in capital outflows from Asian markets continued in 2017, with some US\$45.2 billion in outbound capital directed into global property assets in the first half of 2017, according to CBRE, almost double the outflow witnessed during the same period in 2016. The Asia Pacific region now accounts for some 40 percent of global cross-border flows, according to analysts Real Capital Analytics (RCA), roughly the same as North America.

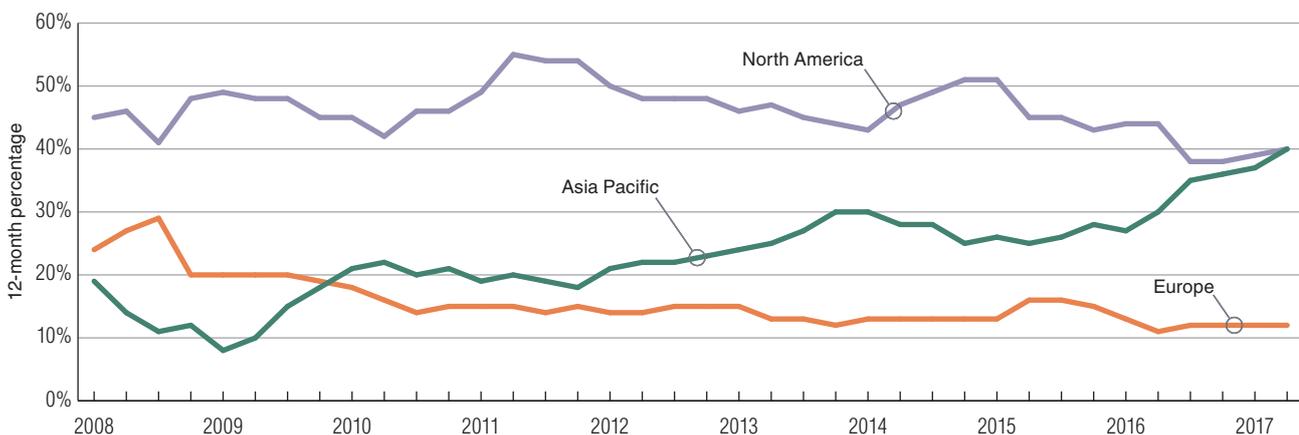
Outflows in 2017 were directed to big-ticket purchases in Western markets and have favored European assets (up 225 percent year-on-year to US\$21.9 billion, although more than half of this was for a single portfolio purchase), with North America receiving some US\$11.3 billion (up 47 percent) and Asia US\$10.4 billion (up 68 percent). Capital moving to Australia declined 25 percent, however, largely as a result of the lack of properties available to buy.

Exhibit 2-2 Recipients of Chinese Capital Outflows, First Half 2017



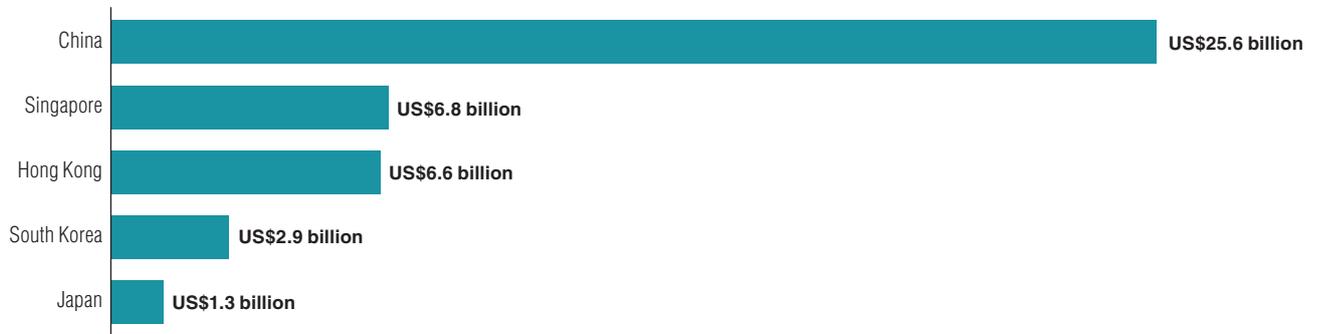
Source: CBRE.

Exhibit 2-1 Sources of Cross-Border Capital by Zone



Source: Real Capital Analytics.

**Exhibit 2-3 Sources of Asia Outbound Real Estate Investment, First Half 2017**



Source: CBRE.

Particularly noteworthy were increased flows from Singapore and Hong Kong to the United Kingdom (primarily London), drawn by falling returns on U.S.-based investments as well as lower relative pricing of U.K. assets in the wake of sterling devaluation. Other investors noted an increase in Chinese and South Korean capital, especially from insurance companies, shifting focus from U.S. to European assets. Finally, in an effort to achieve both scale and an element of local expertise, the number and value of portfolio deals are increasing, often in the form of partnerships with local developers and operators.

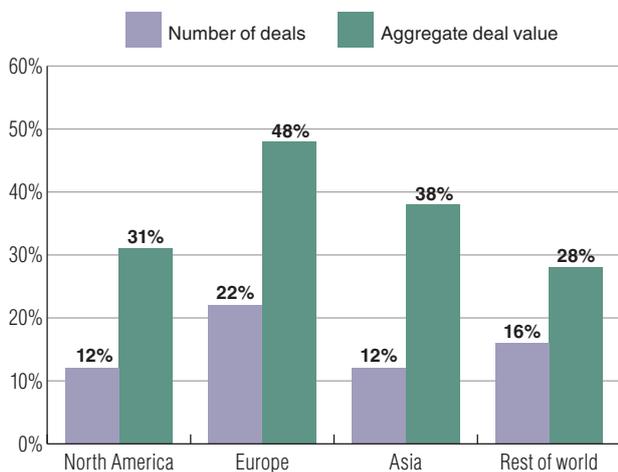
For the time being, the vast majority of Asian capital outflows are moving out of the region to mature markets, rather than to markets within the region. This is a normal strategy for institutions with no prior exposure to global markets, and creates a natural inference that they will rotate back to Asia once they have created significant portfolios in the West. The question is, however, whether sufficient capacity exists locally to absorb so much new capital. Although new investment-grade

stock is being created reasonably quickly, most of it does not trade. Low transaction volumes outside Japan and Australia suggest that most markets would struggle to provide a home for significant volumes of new capital.

### Chinese Developers Reined In

While the biggest supplier of Chinese outbound capital is institutional (its sovereign wealth funds deployed around half of the total US\$25.6 billion in outflows in the first half of 2017, according to CBRE), outflows from Mainland developers have had the bigger impact on regional markets. This is mainly because China's institutional investors are currently focused on markets in the West, while Chinese developers tend to invest in projects in Asia. Bidding by Chinese developers—who are often willing to pay more for development plots than local rivals—has caused land prices to soar in many Asia Pacific cities, and particularly in Hong Kong, Singapore, and Australia. Development site sales in the region climbed 38 percent year-on-year to US\$239.7 billion in the first half of 2017, according to RCA.

**Exhibit 2-4 Portfolio Deals as a Proportion of All Private-Equity Real Estate Deals, by Region, 2016–July 2017**



Source: Preqin.

However, “irrational” recent spending by some Chinese investors has now caught the eye of authorities in China, resulting in the progressive tightening of capital controls beginning in the second half of 2016, and more recently in August 2017. Although the extent of the impact of the August crackdown remains unclear, the consensus is that overall outflows may not see a meaningful decline given firstly that sovereign and state investors will probably be unaffected and secondly that there is already a substantial body of Chinese-owned capital held outside China (much of it in Hong Kong) that is not subject to the rules. Instead, scrutiny will most likely fall on private players, including insurers, conglomerates, and other privately backed enterprises and individuals. Activity by at least some state-owned enterprises will also probably be affected.

The impact of the most recent regulatory curbs on Chinese developer outflows into Asia, therefore, is proving to be significant, especially coming as it does on top of a preexisting

59 percent year-on-year reduction in capital outflows to other regional markets during the first half of 2017. According to one investor active in Australia: “What we are noticing is how sharp the corrections have been. In the past, we’ve seen significant investment activity in Sydney and Melbourne by Chinese developers, and the competitive tension of Chinese capital breathing down their necks has forced other investors to sharpen their pencils. But now they have retreated. That tension is simply not going to be there, so we think it’s going to result in a softening of cap rates and deflate some of the heat in places like Sydney.”

Many investors are now tracking how this plays out given that Chinese projects in Australia “are getting a bit squishy around the edges,” as one fund manager put it. “Most local developers stepped out of the residential market two years ago when they saw this happening, so they have very little product on the market that they’re selling. The only thing that’s being closed and sold now is from the Chinese developers, and we’re starting to see them having a few concerns.”

The same phenomenon has also been noted in the United States and other international markets, with Chinese investors having difficulty closing deals as they wait for the bureaucratic wheels to turn in granting approvals. However, whether any of these opportunities actually appear on the market, or are instead intermediated by cutting unit prices of new-build apartments or via help from affiliated companies (as is normal in China) remains to be seen.

One further way in which Chinese capital controls may affect investment outflows is by redirecting them to markets that enjoy preferential status with Beijing in policy terms. Several interviewees suggested that this may therefore result in increased flows from China to Hong Kong, either for the purposes of investment in that city or for re-export elsewhere in the world. Perhaps unsurprisingly, Hong Kong was the largest net recipient of incoming capital (mostly from China) in the first half of 2017, up 87 percent year-on-year to US\$8.6 billion, according to RCA. That said, activity by Chinese developers in Hong Kong has dropped away significantly in the second half of the year. In addition, investments in countries involved in China’s “One Belt One Road” infrastructure policy initiative may also be treated more favorably by regulators.

## Japanese Outflows Inch Up

Another huge source of Asian capital yet to appear in global markets in any size is Japan. Led by the US\$1.3 trillion Government Pension Investment Fund (GPIF), Japan’s major public pension funds decided several years ago to create a 5 percent allocation to real estate assets, and have hired several real estate managers to oversee implementation. But while low domestic yields and a shortage of suitable assets mean that Japanese public and corporate pensions have little choice

but to venture outward eventually, they have so far been slow to test the waters.

According to one fund manager involved in talks with the GPIF: “They’re talking and making us dance a merry dance, completing what must be the world’s longest-ever RFP [request for proposals]. But I think there is probably a certain amount of nervousness in Japan—and probably rightly so—that they risk making the same mistakes they made last time round, so they are going about it in a much more structured, professional way, and not just turning up in New York and buying the Rockefeller Center.”

Other interviewees also commented on the deliberate approach of the Japanese pension funds. While moving painfully slowly, managers are studiously avoiding the strategy of large one-off deals via direct investments adopted by many other large institutional investors in Asia as they move into foreign markets. “They are investing in a way I always thought investors should invest,” commented one fund manager. “By which I mean starting with open-ended funds then moving to separate accounts or maybe closed-end funds, then to one-off deals. I still can’t get my head around the way other Asian institutions are doing this, where the last thing you should do is the first thing that you do.”

A few public and corporate pension funds, however, have now begun investing into open-ended funds in mature markets, with the lion’s share of outflows heading to the United States. According to RCA data, Japanese investments in U.S. properties amounted to US\$1.3 billion in the first half of 2017, up some 79 percent year-on-year.

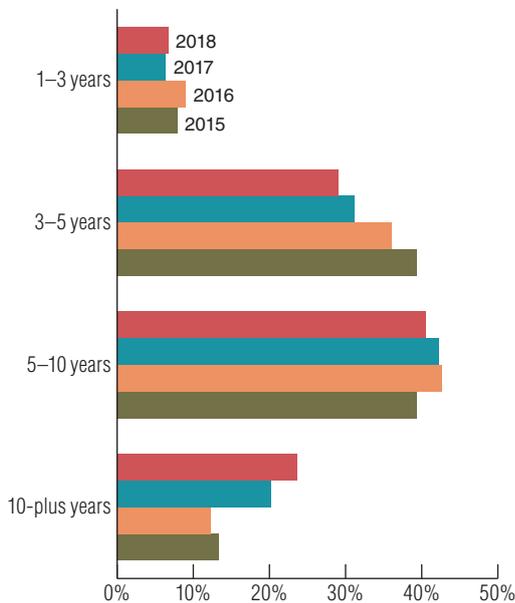
## Asian Outflows Will Only Increase

Quite apart from the impending arrival of a glut of Japanese capital, the long-term trend of increased outflows into individual Asian markets is almost certainly set to continue given the fundamental fact that more capital is being generated in local economies than they can absorb domestically. Other factors add to this affect, including the need to diversify risk, the need to adjust allocations to different asset classes in accordance with international norms, and the diminishing returns now available for investments in many domestic assets or projects.

In particular, and notwithstanding the recent regulatory crackdown, interviewees agreed there is little prospect of any significant slowing in outgoing flows from China over the long term, especially since authorities are now able to witness the extent to which property yields have been squeezed as a result of the most recent round of restrictions.

According to one Hong Kong-based fund manager: “I don’t think you’re going to see China stopping money coming out. In practice, capital movements are probably mostly dependent

**Exhibit 2-5 Time Horizon for Investing**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

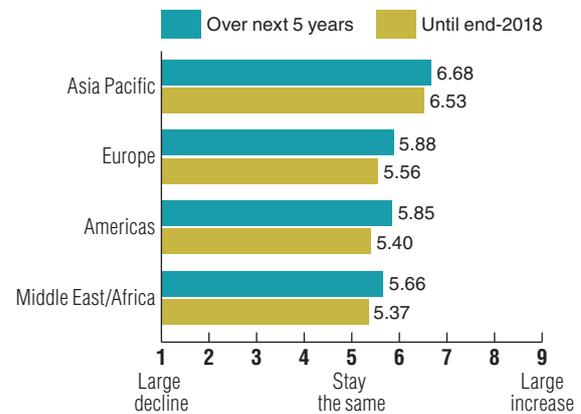
on where the renminbi is and whether it stays stable. And we've just had a period of relative [currency] stability, so outward movement is slightly easier than it was when foreign reserves got down to Rmb3 trillion or so. It's just that Beijing doesn't speak with one voice, so certain people can't get money out at certain times. I look at it from the perspective of the experience we've had in Hong Kong—you're going to continue to see insurance companies coming in either openly or not so openly and being part of the big deals here."

The rapid increase in the amount of institutional capital now active in the region, both from within Asia and from global sources, continues to have an impact on the length of time assets are being held. This is not simply a question of the preference among institutional investors for longer investment timelines. The overarching theme emerging this year of investors prioritizing yield over rental or capital growth reflects a preference for holding high-quality assets providing conservative but safe returns over the long term. Survey results confirm this dynamic, with a pronounced shift in favor of both five-to-ten-year investments and more-than-ten-year investments.

### Incoming Flows Beginning to Rise

U.S. and European institutional funds have for years opted not to boost allocations to Asia to correspond with regional economic growth. Today, however, sentiment appears to be improving, driven both by the need to tap Asia's higher economic growth in order to improve long-term returns, and to diversify away from markets in the West that are by now fully valued and where most of the low-hanging fruit from the global financial crisis has already been absorbed.

**Exhibit 2-6 Change in Capital Flows into Asian Markets, by Region**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

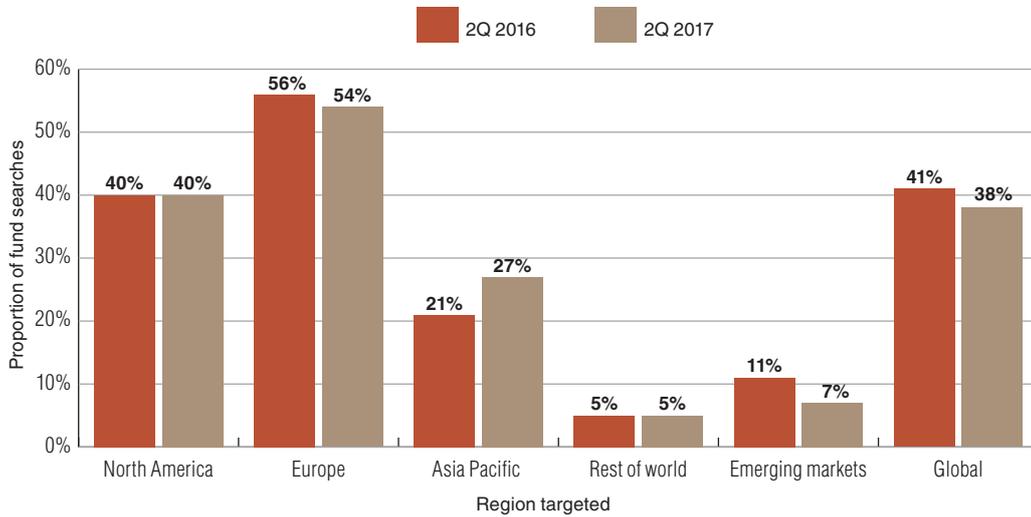
Flows into Asia from the United States continue to outweigh those from Europe. Historically, they have tended to be directed to the value-add or opportunistic space, principally for the purposes of return enhancement. Strategies are gradually evolving, though. According to a manager at one fund currently raising capital in the United States: "Where I'm seeing things change now is that we're probably seeing an increase in U.S. capital in the value-add fund we're raising right now compared to what we raised in the previous one. We're also seeing more U.S. capital going into Asia core vehicles. So, what we're seeing now is that in addition to the enhanced return, diversification is also playing a part. I think there's also partly an acknowledgment that property values have become topky in a lot of markets in the U.S., so diversification is more important now, too."

European investors, meanwhile, have until recently remained largely focused on European assets, but are "now starting to see Asia through a different lens," according to a manager at a European-based institution, who noted increasing interest from northern European players looking for core and core-plus investments.

According to one Hong Kong-based fund manager: "I'm definitely sensing an increased appetite for European investment in Asia compared to four years ago, when we raised our first Asian funds and just 7 percent of capital was from Europe. At the time, they were very risk-averse after the global financial crisis, and I think they've taken a long time to rebalance and move back up the risk curve."

Investors from Middle Eastern institutional sources have been prominent in the market for the last several years, but activity appears to have slowed recently, although they remain generally active in canvassing deals. As one fund manager

**Exhibit 2-7 Regions Targeted by Private Real Estate Investors in the Next 12 Months, 2Q 2016 versus 2Q 2017**



Source: Preqin.

commented: “I think it’s true that the troubles they’ve had and the decline in oil prices have had an impact, but at the same time we are seeing more and more Middle Eastern institutions, both sovereign wealth and pension funds, that haven’t invested in the Asia Pacific before are now starting. Being new and inexperienced, they’re coming into funds.”

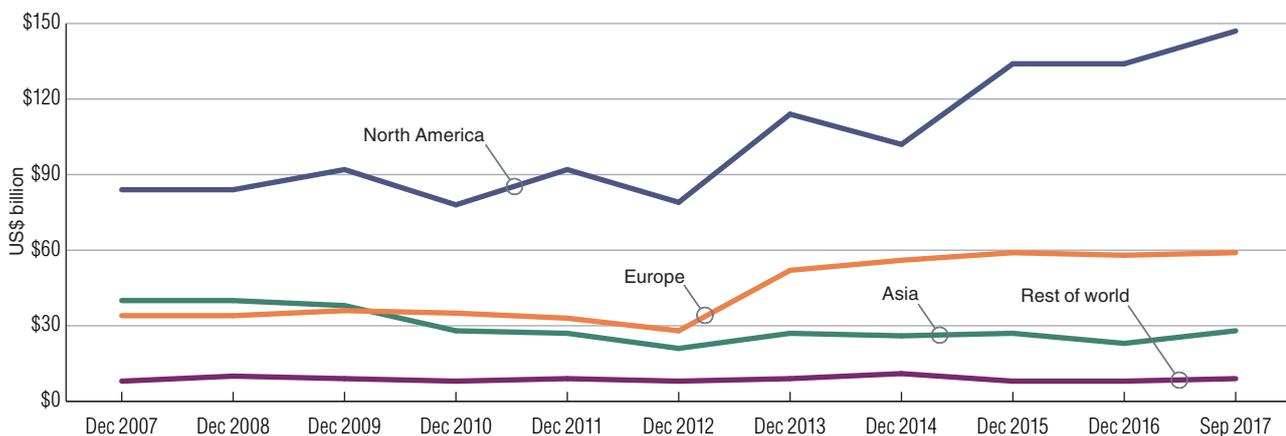
### Fundraising

In general, raising capital remains as difficult as ever for most regional funds, although the same dynamic from previous years in favor of large, established funds or smaller, specialist players continues. As one fund manager raising capital for a fund focused on themes of demographic change said: “We were heartened by the fact that there was appetite from U.S.

investors for a core-plus strategy, and I think a lot of it was that it wasn’t a me-too strategy that a lot of the core funds are using—so education, an aging demographic, e-commerce [i.e., logistics] were the key themes which gave us a strong response.”

Unlike in other global markets, funds in Asia do not have particular problems with excess “dry powder.” But with so much competition to buy assets, there is still a backlog when it comes to funds getting capital into the market, especially for those looking to deploy it in large amounts. As a result, institutions are increasingly looking at club or direct deals instead of waiting in line with open-ended funds. As a manager at one European institutional fund said: “The issue is the gap between committed and deployed capital—sometimes,

**Exhibit 2-8 Closed-End Private Real Estate Dry Powder, by Fund Primary Geographic Focus, 2007–2017**



Source: Preqin.

committed capital is pretty large and deployed capital has been slow out the door. We faced that issue, too, so we now try to get into deals with a manager where we know at least the assets are ring-fenced. Otherwise, you end up with situations where you've missed the cycle in the Asia Pacific and your capital stays uninvested."

While the number and size of open-ended core funds in Asia remain tiny by Western standards, demand is steadily increasing as more investors begin to opt for steady yields rather than big returns. However, local money continues to be hesitant about placing capital with regional funds. Although there has been an incremental increase in contributors from within the region, in particular in the opportunistic space, the vast majority of assets under management—particularly for core funds—still comes from non-Asian investors.

While one interviewee described this preference among local institutions for direct deals in the core space as "sovereign wealth fund mentality," another suggested it stemmed in part from the flawed way that regional core funds are often structured (i.e., as Pan-Asian open-end funds). While open-end structures offer benefits to investors via generally lower fees and transaction costs (as a result of fewer property sales), they are not necessarily the best approach: "To invest in a U.S. dollar-denominated fund that co-mingles markets as diverse as Japan, China, and Australia, and have to roll all the different lease structures, currencies, taxes, ownership structures, and the economic and property-market cycles into one product is fundamentally not what core investors are looking for. Those markets are all being lumped together at the moment because of a drive by managers to create longevity of fee revenues rather than because the investment thesis makes sense."

Whatever the cause, local capital continues as a rule to avoid investing through such core funds. Although one fund manager indicated his fund had for the first time received money raised from Mainland Chinese wealth managers and insurance companies, he estimated that no more than 5 percent of core fund capital in the region was currently sourced from within Asia, compared with rates of some 80 percent to 90 percent domestic participation for equivalent funds in the United States.

This may change when Asian institutional capital—particularly Japanese pension and Chinese insurance companies—have filled their boots in the West and decide to direct more attention to regional markets, an eventuality that would be welcomed by core fund managers given that return expectations among locals tend to be more realistic than those of investors from Western markets. Until that happens, however, "core funds in Asia will remain subscale and therefore challenged."

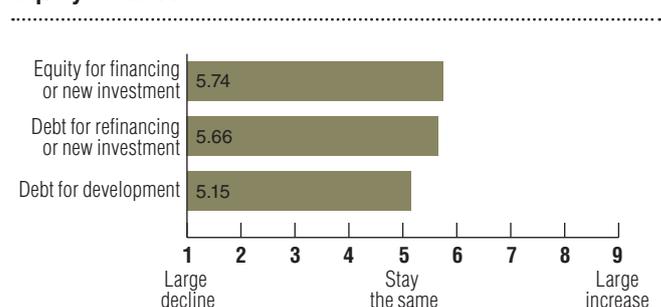
## Banks Tighten in Some Markets

As a general rule, regional banks remain the obvious source of finance for real estate deals. Levels of liquidity regionally remain very high and in most markets big investors found banks more than ready to provide capital to finance deals for prime assets, as they have for many years.

At the same time, however, some interviewees spoke of how certain types of deals in certain markets were becoming harder to finance, creating a degree of concern going forward that banks are preparing to tighten standards and increase the cost of capital. According to one Singapore-based opportunistic fund manager: "We are seeing some significant tightening by lenders in selected markets—notably Australia and China—and we think there's some inevitable fallout from that which creates some interesting investment pipelines."

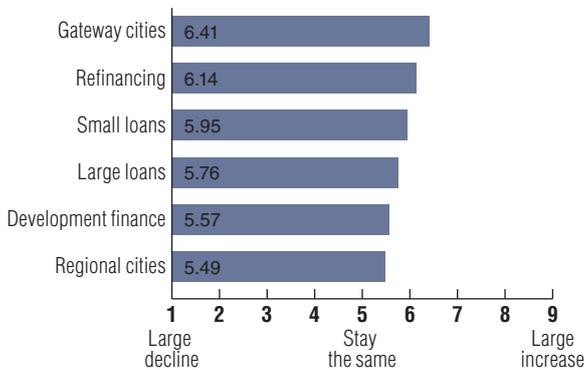
- In Australia, "banks continue to provide extensive credit to strong players, but their stance regarding smaller or weaker players is leading to a tightening. They are also becoming more selective." Loan-to-value (LTV) ratios in Australia have recently pulled back from 60 to 65 percent to 55 to 60 percent. Changes apply in particular to the residential sector, where lending to developers has been reduced. Grade-B property purchases also are receiving more scrutiny.
- In China, where the government's control of bank lending policies allows it to cut or increase developer access to finance as a means of managing housing supply and pricing, the government is addressing the latest upward leg of home prices by (among other things) drastically reducing bank loans for construction and land-purchase purposes. Coming on top of shrinking margins and lower home sales as a result of a simultaneous government squeeze on mortgage availability, this move has placed smaller developers in peril. As usual, the response within the industry has been to seek out alternative sources of capital. A number of resourceful alternative financing

**Exhibit 2-9 Change in Availability of Debt and Equity Finance**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

**Exhibit 2-10 Change in Availability of Different Types of Debt**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

channels have evolved over the years, including the trust sector, the peer-to-peer lending industry, domestic bonds, and asset-management plans.

- In Japan, the cost of bank debt remains the lowest in Asia, with even foreign investors able to borrow at under 1 percent. Even so, availability has recently tightened. In June 2017, the Bank of Japan's Diffusion Index, which measures banks' willingness to lend, recorded the largest single decline since the global financial crisis, as major banks became more selective about who would receive funding in tightly priced transactions. This is a significant development even though the cost of debt seems largely unaffected and a recent decline in transaction volumes

**Exhibit 2-11 Policy Interest Rates in Asia ex-Japan**

Market	Interest rate*	Number of rate cuts in 2Q 2017	Change in 2Q 2017
Australia	1.5%	0	0 bps
China	4.35%	0	0 bps
Hong Kong	0.78%	0	-16 bps
India	6.25%	0	0 bps
Indonesia	4.75%	0	0 bps
New Zealand	1.75%	0	0 bps
Singapore	1.00%	0	+5 bps
South Korea	1.25%	0	0 bps
Taiwan	1.375%	0	0 bps
Thailand	1.5%	0	0 bps

Sources: CBRE Research, various central banks and monetary authorities, second quarter 2017.

\*Rate at end of July 2017.

Notes: bps = basis points. Policy interest rate: Australia = cash rate; China = one-year lending rate; Hong Kong = three-month HIBOR; India = repo rate; Indonesia = seven-day repo rate; New Zealand = official cash rate; Singapore = three-month SIBOR; South Korea = base rate; Taiwan = discount rate; Thailand = one-day repo rate.

means that banks (which still have vast amounts of cash to deploy) cannot be so choosy about borrowers.

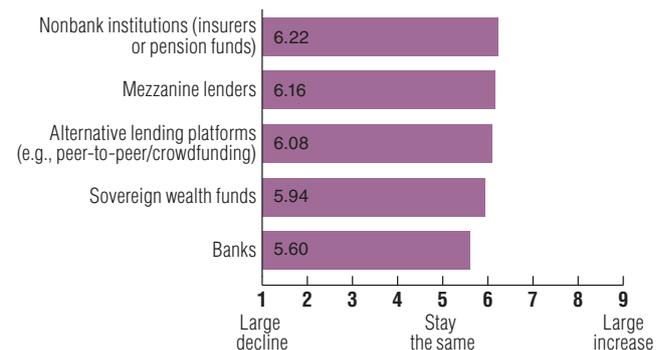
Investors in other markets tended to echo the theme of a slowly evolving background of tighter lending policies, without any profoundly negative shifts. In Hong Kong, for example, one fund manager noted that bank lending decisions are “more likely to be based on how much of their annual target they have put out and your own relationship with the bank. The [authorities] continue to monitor local banks very carefully—they can't lend more than 40 percent loan-to-value and there are increasing restrictions on how much they can lend on the construction piece as well. So, policy is tighter, but I wouldn't say it is drastically tighter.”

### New Financing Options Evolving

With tighter bank lending regimes now in the air and ever-shrinking returns to be made from investments in conventional real estate, a number of debt funds have now been established across the region, in particular in Southeast Asia, many of them involving local capital. As one fund manager who was considering entering this area explained: “I think there's opportunity to position your investment at a second-loss position—in other words, either preferred equity or mezz [mezzanine], because there's a funding gap evolving where senior lenders are providing a lower level of leverage. So, we can come in at 50 to 70 percent LTV and still get very attractive risk-adjusted returns with some equity buffer above.” At the same time, however, “where banks are retreating it can often be for good reason, so you need to be very cautious and filter who you're going to lend to. Mostly, those that require money are the ones you don't want, so there need to be strong filters. But it's going to be a good harvesting opportunity over the next two or three years.”

Anecdotally, however, most of these new providers of debt are small-scale and have so far met with limited success, partly because structuring debt deals in Asia is far from straight-

**Exhibit 2-12 Availability of Debt by Type of Lender**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

forward and partly because of competition from banks, which are for the most part still quite willing to provide liquidity. As one Hong Kong-based fund manager observed: “We see them [i.e., debt funds], but we haven’t really seen them deploying capital—it’s quite difficult for them to make their pricing attractive in Hong Kong.”

That said, certain markets provide more opportunity than others. In particular, Australia has seen some significant recent developments in this area. In the nonbank debt space, various investment banks, sovereign wealth funds, and large private equity players have entered the market with a view to filling a gap in the market to provide debt where local banks will not, most obviously as a way to top up LTV ratios for residential developers and also nonprime office developments. In one recent case, an American investment bank provided funding to a project in Melbourne involving Mainland Chinese investors.

In addition, others are positioning to compete directly with the big four incumbent banks, whose effective stranglehold over the market has led to a fairly restrictive financing environment, including in particular short tenor on loans. A number of Japanese and Chinese banks have now appeared in Australia, the former to escape cripplingly low returns in their home market, and the latter to provide financing options to Chinese investors. In addition, Australian superannuation and various foreign investors are looking for opportunities. According to a manager at large global insurer: “We’re evaluating a direct lending business in Australia where we could lend senior at 50 percent to 60 percent LTV and long tenor, which is not really available on the market. We have the ability to lend at ten to 20 years, which other people can’t do.” Foreign players without access to balance sheets featuring a local-currency income stream are

hampered, however, by the need to hedge their exposure—a significant extra expense given the generally high cost of hedging for the Australian dollar.

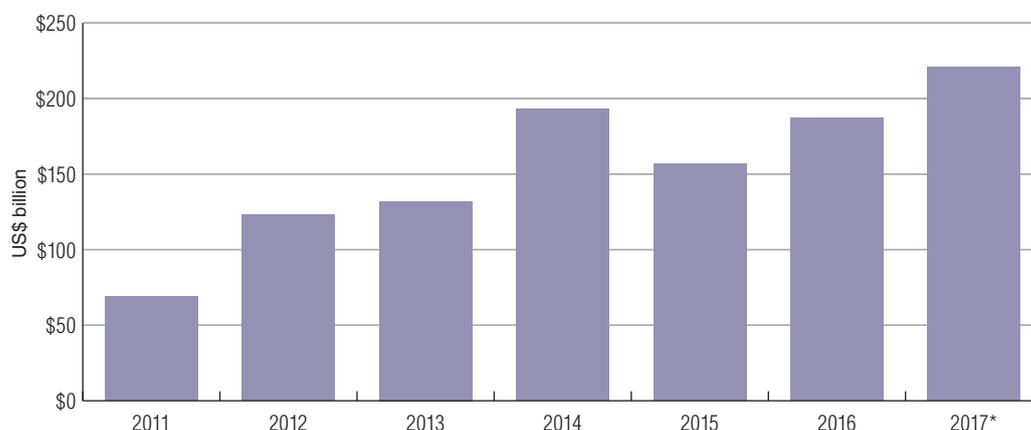
Japan is also a market drawing foreign interest in this area, and again the focus is on tenor, either in the form of longer-term debt or short-term bridging loans. Mezzanine debt is also available in China, with returns reputed to be in the area of 25 to 30 percent. For foreign investors, however, mezzanine deals in China may be playing with fire because local regulations raise issues of priority in the event of bankruptcy that may relegate them to the bottom tier of creditors, depending on how the deal is structured.

The one market where mezzanine continues to be a major factor in structuring investments is India, where the going rate stands at around 16 to 18 percent, according to one locally based interviewee, compared with standard construction lending of 12 to 13 percent from local banks. Low tax leakage makes it a popular option among foreign investors, with demand for funding currently coming in particular from local residential developers trying to meet newly imposed regulations requiring timely completion of residential projects.

## Bonds

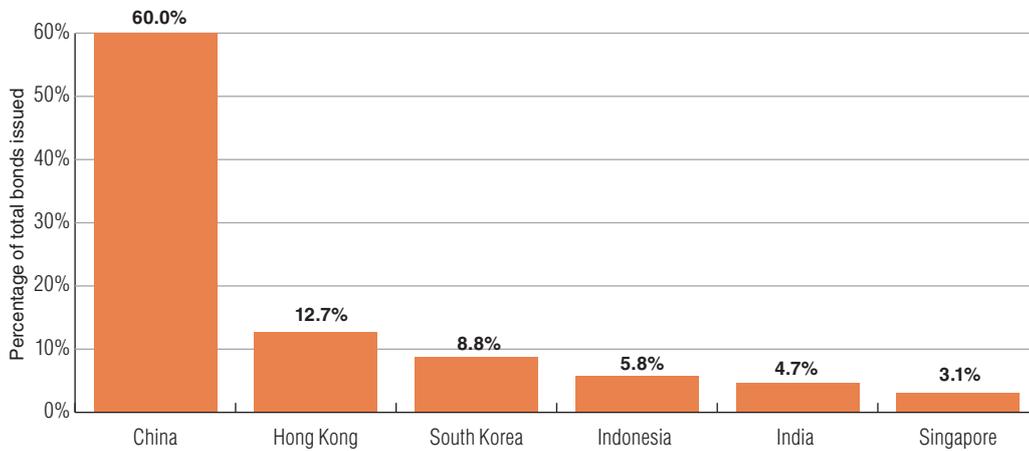
As a financing channel, local bond market issuance still represents a small fraction of development funding provided by regional banks. Nonetheless, the bond markets are growing rapidly. Total sales of Asia ex-Japan foreign currency corporate bonds reached US\$221 billion in the first nine months of 2017, already higher than full-year issuance in any previous year. Of this, about half came from real estate developers, and most of that hailed from China, with the majority of offshore

**Exhibit 2-13 Asia ex-Japan Corporate Bond Sales, 2011–2017**



Source: Bloomberg.  
\*Through September.

## Exhibit 2-14 Asia ex-Japan U.S. Dollar Corporate Bond Issues



Source: Bloomberg.

Note: Data are for 2017 through September.

bonds issued in Hong Kong. The total amount of foreign currency bonds outstanding across the region is expected to top US\$1 trillion (up from a current US\$730 billion) within three years, according to projections by Australia's ANZ Bank.

Quite apart from the rapid rise in the number of local bond issues, local investor appetite for Asian bonds has also increased rapidly in recent years, to the point that demand from regional—and especially Chinese—buyers is today easily enough to absorb the vast majority (some 79 percent in 2017) of new issues in the region. This newfound demand for Asian corporate debt means that bond markets have become less volatile due to local investors' differing perceptions of risk—be it economic, regulatory, or geopolitical. This has brought a certain amount of stability to bond markets that in the past were often notoriously volatile.

As a result, yields for foreign-currency Chinese developer bonds have remained low even after the imposition of government measures aimed at cooling demand in China's residential sector took effect in 2016. "International investors were concerned about how this would affect developer earnings and began to ease off buying their bonds," said one interviewee. "But it didn't have any impact because local buyers stepped up anyway. And now the international demand has come back, which has forced yields down more."

Regulators limited the number of new offshore issues by Chinese developers in the second quarter of 2017, before relaxing restrictions in the second half of the year. Since then, developer issues have spiked. As an example, a US\$200 million issue in August 2017 by a prominent Chinese developer, rated at BB– by rating agency Moody's, was ten times oversubscribed, pricing at 5.12 percent before tightening to

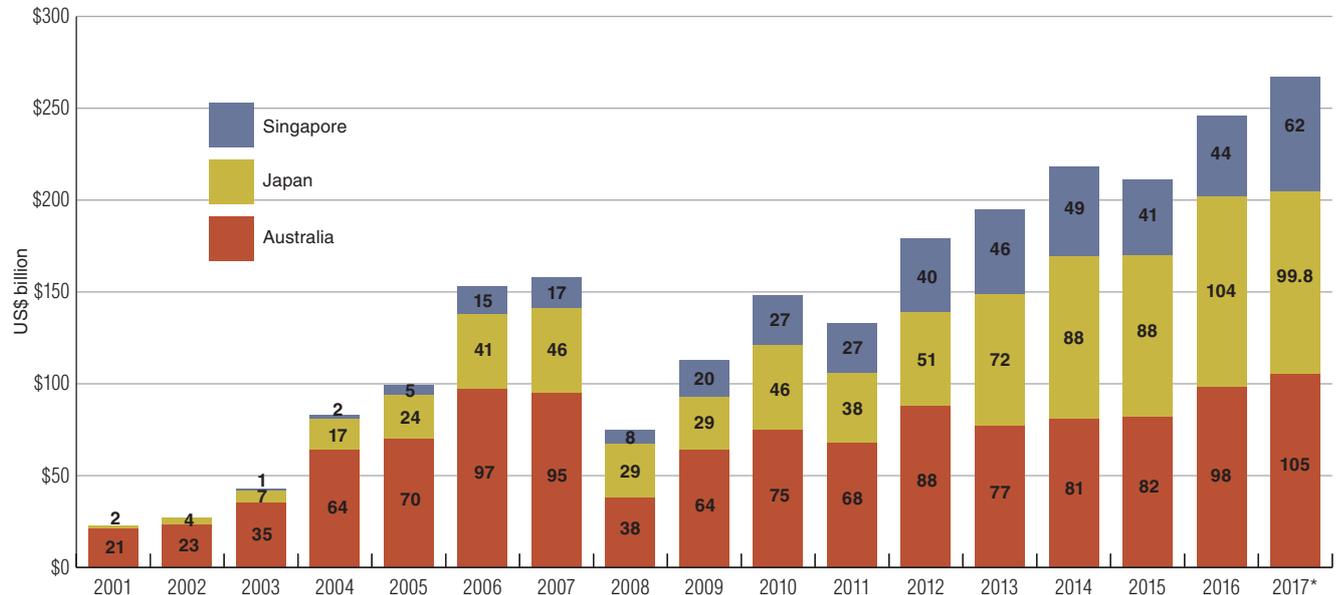
4.03 percent in October. While that seems low for a supposedly high-yield bond, even priced at these levels bonds are generating higher returns than equivalent issues in Western markets. One reason that both foreign and local asset managers are prepared to buy at such tight yields is the general expectation that large developers will enjoy implicit support from the Chinese government in the event of a default.

China's local currency bond market, meanwhile, surged after government restrictions were relaxed from the beginning of 2015, allowing smaller developers who could not access offshore bond markets the ability for the first time to issue their own debt. Favorable pricing quickly made this the go-to source of funding for developers (replacing loans from trust companies), but as China's home prices soared and doubts rose as to whether bond yields accurately reflected market risk (looser scrutiny means that about two-thirds of all corporate debt in China holds the highest AAA rating), authorities in October 2016 once again imposed restrictions on local bond issuance. These were relaxed in July 2017 in order to head off a funding crisis for developers, but issuance is thought unlikely to return to previous highs any time soon.

## REITs

With base rates seemingly set for a long period of incremental increases, REITs in the Asia Pacific region (apart from Japan) have continued to show surprising resilience. At the same time, signs are emerging that REITs' appeal may be weakening, as global equity markets continue to rally on better growth prospects and the likelihood of higher interest rates dims the attraction of an asset class that tends to trade in line with fixed-income assets.

**Exhibit 2-15 Market Capitalization of Listed REITs in Asia Pacific**



Sources: Real Capital Analytics, Bloomberg, Deutsche Asset Management.  
 Note: Figures exclude land acquisitions and developments, hospitality, and apartments/residential.  
 \*As of October 2017.

There has also been rising speculation that smaller REITs in Asia Pacific markets may be subject to takeovers. This is mainly because they offer the scale that deep-pocketed investors are seeking at a time when assets have become increasingly hard to source. In addition, many regional REITs are overleveraged (not ideal with interest rates rising), or trade at a discount to net asset value (NAV), which in turn boosts their appeal as a break-up play. In Singapore, there is added pressure to consolidate given the high numbers of properties already owned by domestic REITs, which therefore provide limited possibilities for organic expansion at home. In addition, many Singaporean REITs, especially those in the logistics sector, are in the midst of a cyclical downturn. Already, there have been several REIT takeovers in the region in 2017, with a number of others probably in the pipeline as potential buyers circle.

Still, takeovers are not straightforward. REITs in some markets—in particular Japan and Australia—often have external sponsors with large shareholdings who may be difficult to oust. Others (particularly in Japan) have adopted “poison pill” strategies aimed at deterring takeover bids. In addition, according to one local REIT manager: “You need to have capital at short notice, so deep pockets are needed for the buyers because the capital markets may not give them the money. And then, as far as the corporates on the real estate side go, they can be trading at huge discounts to NAV. Although in principle this makes them targets, unless someone is willing to pay a recognizable premium to the current valuation, it’s

difficult to accumulate sufficient stock to execute a successful takeover. So you’ll rarely see someone making a move on a larger company, even if liquidity is rather high. More often than not, the company would buy back shares if the price is too low.” Nonetheless, the path of least resistance appears to be in favor of more takeovers to come.

**Japan**

The boom in the J-REIT market sparked by the government’s quantitative easing and REIT-buying program appears to have faded in 2017. The local TSE REIT index was down some 8 percent year-on-year as of the end of October, even as equities markets have advanced. At the same time, J-REITs are trading at a premium to NAV of around 9 percent, higher than other markets but well under their high of 58 percent at the beginning of 2015. This decline is partly due to institutional selling in anticipation of rising interest rates, and partly to selling by domestic mutual funds—holders of about 20 percent of the entire J-REIT market by value—in the wake of an investigation by local financial regulators into their risk management practices.

As a result, there has been a change in the dynamics of REIT buying, with funds now opting to invest via exchange-traded funds. While this appears to satisfy regulators, it has created a distortion in the way that funds are channeled into the market, meaning that more capital is now being directed to smaller, lower-rated REITs. Share prices at these vehicles have risen, therefore, even as those at bigger REITs have fallen.

While the government's continuing support to the sector should help prop up prices, J-REIT yields remain compressed at an average 4.2 percent as of the end of October 2017. This represents a healthy 420-basis-point spread over the price of the sovereign bond, but J-REITs remain pricey by the standards of other regional markets. At the same time, rising prices of new assets mean they are finding it harder to purchase at levels that provide an accretive yield. Although J-REIT acquisitions still represent approximately 60 percent of transactions in Tokyo (and are one of the main reasons that foreign investors find it so difficult to buy core assets there), purchasing activity has declined in 2017, according to interviewees, while government rules requiring increased transparency have reduced the number of new listing candidates.

### Australia

With interest and bond rates set to rise and Australian banks beginning to tighten lending requirements, share prices at A-REITs have faltered from first-half highs in 2017, with Australia's ASX 200 A-REIT index standing at a loss of around 4 percent at the end of October, compared with a flat performance in the broader equity market. Yields, meanwhile, were around 6 percent. Retailing REITs have been the worst performers due to negative sentiment stirred up by the imminent arrival of U.S. e-tailer Amazon in the Australian market. For the same reason, logistics REITs have outperformed.

While A-REIT shares have been supported to some extent by the prospect of ongoing rental increases across the board for commercial properties, rising gearing is a looming problem, with a growing number now approaching or exceeding the 40 percent leverage threshold.

That said, recent asset sales by A-REITs have been strong, often fetching well over book value and suggesting that A-REIT valuations may be conservative. In addition, A-REITs are currently trading above their historical spread to the local sovereign bond, suggesting that rising interest and bond rates can to some extent be absorbed within that spread without pushing cap rates out. Finally, a number of A-REITs have successfully raised equity in 2017 for the funding of new acquisitions. This bodes well, and with real estate continuing to be attractive as a defensive asset class, capital raising is expected to continue going forward.

### Singapore

Total returns from Singapore's SGX S-REIT index amounted to 21.4 percent in the first nine months of 2017 (with yields averaging 6.4 percent), a handsome return for a market where domestic real estate has been in a multiyear slump.

Still, with the market in Singapore saturated, speculation persists of further consolidation in the REIT sector as weaker

S-REITs are absorbed by bigger players or cashed-up corporate rivals. And with significant new supply in the pipeline across several asset classes (especially retail), headwinds for REITs are likely to continue, notwithstanding a recent firming of rents in the office sector.

Meanwhile, many S-REITs continue to look abroad to source new assets. Australia remains a favorite stomping ground, although a lack of stock and the high pricing of available assets have seen transactions from foreign investors dip in 2017. South Korea was noted for its "buoyant logistics market that hasn't yet been tapped for securitization."

China, meanwhile, still has its followers, but concern about operational difficulties is growing. As one Singapore-based REIT manager observed: "It's everything from the volatility to the regulatory risk. They change a few things along the way and boom, your whole model goes out the window. The guys in private equity take a shorter-term view, and they can get in and out, or get around certain issues along the way. But ours is a longer-term play, and too often you find you're subject to the potential of additional taxes or some other issue that's tweaked to align with their own objectives."

### New REIT Markets

Various REIT frameworks that have been in the works for years in several Asian jurisdictions have inched closer to realization in 2017, but the sticking point as usual remains the crucial issue of tax exemptions. **The Philippines** is one such market. Investors had hoped that the most recent administration would move to implement the required reforms, but government officials appear to be unconvinced that tax breaks would be sufficiently beneficial to the domestic economy.

**China** is another market where the tax-exemption issue has yet to be resolved. There do appear to be signs of progress, however, with rumors circulating that authorities are on the brink of releasing new regulations for a rental property-based REIT that will be sold to retail investors on domestic public markets by the end of 2017. Others remain skeptical, however, pointing to the problem of super-compressed yields on Chinese real estate as runaway capital values far outstrip rental increases.

**India**, therefore, remains the real bright spot. Despite enduring cynicism that India's suffocating bureaucracy would effectively snuff out the chances of any early introduction of the country's first REITs, there now seems a real prospect that India's maiden REIT will be listed by the end of the first quarter of 2018.

The remaining problem for REITs in India, therefore, appears no longer to be a regulatory logjam, but rather the question

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of how to price real estate assets at a level that will appeal to both sponsors and REIT shareholders. As one fund manager observed: “REITs in Japan and Australia and Singapore are trading at yields that are about 370 to 450 basis points above their ten-year government bonds. And India’s ten-year government bond now is at about 6.6 to 6.7 percent, so arguably the trading yield of the REIT should be at least 300 to 400 basis points above that. But from the perspective of the developer or the issuer or the sponsor, the question is: ‘Why do I have to go through a REIT to get that kind of return when I can sell the assets into the market and get better prices?’ There are prospects for growth, of course, but the question then becomes where do you draw the line?”

On the other hand, demand in India for a legitimate institutionalized investment opportunity at the retail level is very high, and may persuade investors to pay up for REIT shares at higher levels. According to one locally based consultant: “Indian stock markets today are currently at an all-time high, with every single new recent IPO subscribed many times over. So, I think from a financial market perspective, Indian markets would be willing to pay a decent price. Then the Indian domestic story is also very strong—lots of money coming from the Indian middle class is finding its way to the stock market. So, with real estate direct investments currently looking very stark on the residential side, and in the absence of quality investment alternatives, I think it’s very likely that people would consider investing into the office space through the REIT route as a viable option, even if it’s expensive by industry norms.”

# Markets and Sectors to Watch

“From an occupational market point of view—which is where for core investors the long-term value lies—the question is **where can we drive demand** and where we can get the rental growth—and today that’s just very difficult.”

The survey results for this year’s *Emerging Trends in Real Estate® Asia Pacific* report reflect a combination of cross currents—some of them strikingly different—created by different types of investors as they pursue a range of different strategies.

Most obviously, there is a growing divergence between investors embracing either growth- or yield-driven approaches: on the one hand are those looking to maximize returns in an environment where ever-growing competition has squeezed yields to historical lows. On the other hand are those—usually larger players fleeing near-zero returns in sovereign bonds—seek-

ing stable long-term yields that may appear vanishingly low to investors pursuing more conventional investment strategies.

Others still, meanwhile, are focused on tapping returns associated with long-term economic growth in developing markets like India and Vietnam. As one fund manager said: “We go in with a long-term perspective about being there for the next ten to 20 years and being part of this stellar demographic cycle. There is retail consumption, there is office demand, IT demand, domestic demand that hasn’t come out yet. So you talk about capital appreciation, finding the high yield and

Exhibit 3-1 City Investment Prospects, 2018

	generally poor	fair	generally good
1	Sydney	5.97	
2	Melbourne	5.96	
3	Singapore	5.67	
4	Shanghai	5.66	
5	Ho Chi Minh City	5.66	
6	Shenzhen	5.41	
7	Tokyo	5.33	
8	Guangzhou	5.28	
9	Auckland	5.23	
10	Osaka	5.12	
11	Beijing	5.10	
12	Mumbai	5.04	
13	Hong Kong	5.04	
14	Jakarta	5.01	
15	Bangalore	4.96	
16	Bangkok	4.90	
17	China – second-tier cities	4.83	
18	Manila	4.79	
19	Seoul	4.78	
20	New Delhi	4.75	
21	Kuala Lumpur	4.52	
22	Taipei	4.45	

Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

Exhibit 3-2 City Development Prospects, 2018

	generally poor	fair	generally good
1	Sydney	5.81	
2	Ho Chi Minh City	5.76	
3	Melbourne	5.68	
4	Shanghai	5.48	
5	Shenzhen	5.47	
6	Singapore	5.42	
7	Auckland	5.33	
8	Mumbai	5.20	
9	Bangalore	5.19	
10	Guangzhou	5.19	
11	China – second-tier cities	5.18	
12	Jakarta	5.17	
13	Tokyo	5.16	
14	Hong Kong	5.01	
15	Osaka	4.99	
16	Bangkok	4.99	
17	Beijing	4.94	
18	New Delhi	4.92	
19	Manila	4.89	
20	Taipei	4.83	
21	Kuala Lumpur	4.77	
22	Seoul	4.75	

Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

hoping for compression. And you also talk about being there for the long term, to be able to get 4 to 5 percent rental growth per year.”

The fact that markets in Australia are able to satisfy two of these requirements at the same time—its gateway cities combine the appeal of a stable investment environment with a combination of relatively good current yields and the prospect of strong rental growth going forward—tick the right boxes for many investors in Asia and explain the strong performances by both Sydney and Melbourne in this year’s rankings.

Other top trends from the *Emerging Trends* survey include:

- **A stronger showing by Tokyo.** Declining prospects for rental growth accounted for last year’s fall in the rankings for what had previously been a top performer. While concerns over rental growth continue, Japan is today a sought-after

destination for yield investors due to the healthy spread between current cap rates and the country’s super-low sovereign bond prices.

- **The resurgence of Singapore,** mainly as a result of investors betting the markets have bottomed after several years of weakness.

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

- Office—buy Ho Chi Minh City, sell Taipei.
- Residential—buy Ho Chi Minh City, sell Seoul.
- Retail—buy Ho Chi Minh City, sell Taipei.
- Industrial/distribution—buy Shenzhen, sell Taipei.

## Top Investment Cities

**Sydney (first in investment, first in development).** In many ways, Sydney’s appeal is the same as it has been for years—as a major city in a mature economy, it is one of a handful of destinations in the Asia Pacific that combines a reasonably deep and liquid market of core assets with a better-than-average yield (for prime office, 5 percent or less).

The big draw this year, however, is that Sydney is still able to offer strong rental growth, with projected net effective increases for office assets over the next three years of 5 percent annually, according to CBRE. Unsurprisingly, Sydney remains popular with international investors, who represented about a third of total transactions in the first half of 2017, according to JLL.

The problem with Sydney, however, is actually finding core product to buy. Office transactions were down some 37 percent year-on-year in the first half of 2017, according to RCA, partly because many of the best assets have already been bought and partly because owners have little incentive to sell. That said, interviewees also spoke of a good supply of incoming stock from funds that will need to divest in order to take profits, with transactions likely to pick up in the second half of the year.

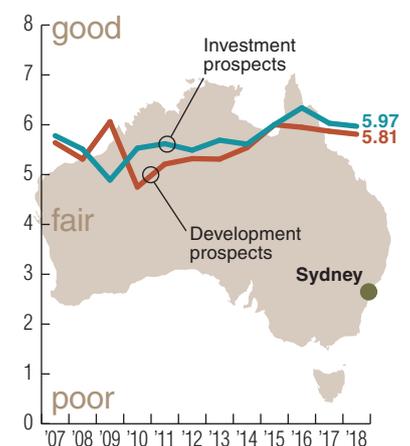
With stabilized assets so hard to find, investors have adopted a number of strategies. Build-to-core and forward

Exhibit 3-3 Historical Investment Prospect Rankings

	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
Sydney	1	9	2	4	5	4	3	6	6	14	15	16
Melbourne	2	16	3	5	13	10	7	9	9	11	17	6
Singapore	3	21	11	9	7	3	1	1	5	2	2	4
Shanghai	4	6	9	6	2	2	2	2	1	5	1	2
Ho Chi Minh City	5	4	5	13	19	18	10	11	13	13	8	12
Shenzhen	6	5	18	19	10	16	—	—	—	—	—	—
Tokyo	7	12	1	1	1	13	16	12	7	1	3	3
Guangzhou	8	10	20	20	6	15	6	8	12	16	9	7
Auckland	9	14	10	15	17	17	20	18	16	17	14	—
Osaka	10	15	4	3	9	22	21	19	18	15	4	1
Beijing	11	11	14	10	8	7	5	7	3	12	6	9
Mumbai	12	2	13	11	22	20	15	3	8	7	10	17
Hong Kong	13	18	15	21	18	11	13	4	2	3	5	11
Jakarta	14	7	6	2	3	1	11	14	17	20	20	19
Bangalore	15	1	12	17	20	19	9	10	14	4	12	10
Bangkok	16	8	19	16	11	6	14	17	19	18	18	8
China – second-tier cities	17	20	22	22	12	8	—	—	—	—	—	—
Manila	18	3	8	8	4	12	18	20	20	19	19	18
Seoul	19	17	7	7	15	14	19	16	4	6	7	13
New Delhi	20	13	16	14	21	21	12	5	10	9	13	14
Kuala Lumpur	21	19	21	12	14	5	17	15	15	10	11	15
Taipei	22	22	17	18	16	9	8	13	11	8	16	5

Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

Note: — = no data.

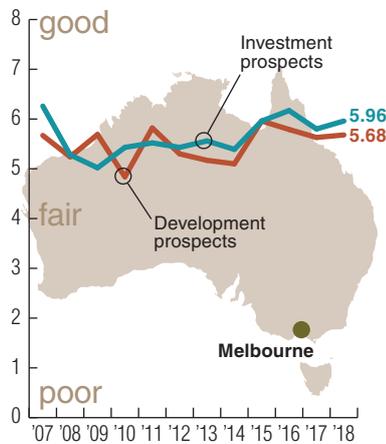


funding remain go-to approaches, while many existing owners (usually domestic funds) are also opting to redevelop older properties in their portfolios rather than trying to buy. As a result, Sydney also ranks first in the rankings for development prospects. A significant number of ongoing projects initiated by mainly Chinese developers to convert Grade-B offices to prime residential sites in the city center are also underway. With some of these now experiencing cash-flow problems as a result of capital control restrictions in China, a number of interviewees indicated potential for providing bridging finance to keep these projects moving forward.

Another option many investors in Sydney, including foreign funds, are now willing to pursue is investing in outlying areas. According to one: "It's incredibly hard to get access to high-quality real estate because it's tightly held, so either you're paying record cap rates or you're going to secondary markets like Parramatta or North Ryde where there's still a very attractive yield spread to the CBD." New transportation infrastructure is now making these outlying districts increasingly appealing.

**Melbourne (second in investment, third in development).** Melbourne's appeal as an investment destination is very similar to Sydney's—a mature market, high-quality core assets, and relatively good yields by Asian standards. Again, occupational markets remain strong, with high demand and little new supply leading to projected 5.5 percent annual net effective rental growth over the next three years, according to JLL. Prime office yields of around 5 percent are expected to compress further over the next couple of years as supply tightens in an environment of strong demand from both foreign and domestic buyers.

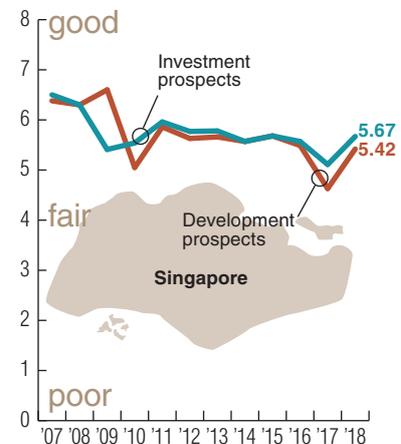
As with Sydney, however, investors are having problems getting money into the market due to a shortage of stock available for sale. Office transactions—



having fallen already in 2016—dropped further in the first half of 2017, to around A\$315 million, or about half the figure recorded in the first half of the previous year, according to CBRE figures. With strong demand continuing, yields are expected to compress further from the current level of around 5 percent.

Residential prices in Melbourne have continued to rise (up 12.1 percent year-on-year in the first three quarters of 2017) in defiance of government containment efforts, driven by strong population growth and rising activity from international buyers, particularly from China. High prices paid for residential plots by Asian developers have also created additional pressure for future price rises, although buying has now fallen off following imposition of tighter rules on capital exports by the Chinese government. With new residential supply about to hit the market and tighter lending restrictions on mortgages leading to slower sales, expectations are rising that the market may have peaked.

**Singapore (third in investment, sixth in development).** After two years of declining rents caused by a sluggish economy and a glut of supply, the promise of a bottom in Singapore's office market has caused its ranking to soar from next-to-bottom last year to third in this year's table. Office rents have firmed probably earlier than expected, while completion of the region's second-



biggest office deal in September 2017 has now galvanized the local market and set a floor for valuations. Several core office transactions have taken place this year, with foreign funds buying actively.

Others, however, see talk of a bottoming as premature. According to one fund manager active in the market: "Singapore's still in a difficult place. They don't have a lot of business confidence, there's quite a lot of supply and not a huge amount of expansion. It's challenging to bring foreign workers in because the government has responded to local concerns to protect jobs, and at the same time a lot of the European banks are downsizing, which hits demand for space. I don't want to be negative, but we're not seeing a big pipeline of deals that interest us."

The residential sector is also showing signs of bottoming, with rising transactions and a slight uptick in pricing for the first time in four years. Driven by buoyant sentiment, sales of developer sites have surged amid tightening supply as developers add to land banks. The rebound seems likely to be sustainable, given the momentum of several years' worth of pent-up consumer demand. Chinese developers have been especially active in buying land, pushing up land auction prices for residential sites significantly through 2017.



**Shanghai (fourth in investment, fourth in development).** This year, Shanghai has performed better than expected. Transactions have been driven partly by surging demand from domestic buyers who have been barred from exporting capital as a result of a government regulatory crackdown, and partly by foreign core funds flush with new capital they need to deploy. As a result, “overbidding has been crazy,” as one investor put it, with yields tightening to under 4 percent in some cases.

That may seem unusually compressed for a developing market, but Shanghai has probably transcended that status given it is already the epicenter for business in China and probably destined to become a major global financial center sooner rather than later. Investors have always played the rental growth/capital appreciation card in Shanghai, often in defiance of conventional wisdom. Given strong ongoing demand for office space, there seems no reason at present to think it will not play out again, even if there is a lot of new supply in the pipeline.

Another reason foreign core investors are now targeting China is that they know that build-to-core strategies will almost certainly find ready buyers in the form of Chinese insurance companies or other institutions happy to pay top dollar for good product. As was the case last year, a lack of available stock in prime locations is driving an increas-

ing amount of current activity into fringe CBD or outlying parts of the city.

Activity from opportunistic or value-add investors, meanwhile, has fallen as investors struggle to find product they can differentiate from what is already available in the market.

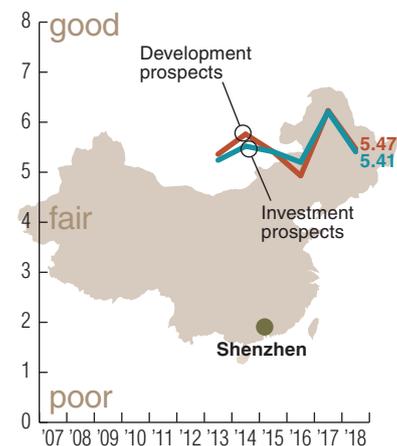
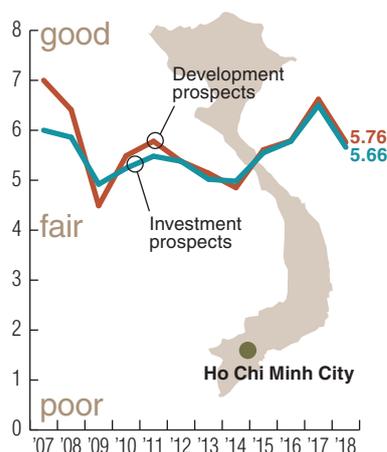
**Ho Chi Minh City (fifth in investment, second in development).** With an economic trajectory thought to be similar to an early-day China, Vietnam now has “a wave of money swilling around” as large regional developers and an increasing number of private equity funds make the bet it will offer up a repeat of the Mainland China experience in terms of property price inflation. Bureaucracy remains an issue, but restrictions are slowly being eased and Vietnam today offers probably better market access than do other Southeast Asian developing economies. It remains a favorite of investors from South Korea and Japan.

Most investors are focused on the residential sector. Home sales and pricing have been strong over the last three years, but in a volatile market there are signs the cycle may be peaking. As one investor in Ho Chi Minh City observed: “Land costs have gone up very, very significantly to the stage where it’s not an opportunistic play anymore in terms of the returns you can get. And when you look at how developers are taking downpayments on condos and using those to buy more land as opposed to

putting them into their own projects, you can see there are strains in the system and that if the sales should slow, the train’s going to stop.”

Given the small amounts of investable stock, those focused on the commercial side will be looking mainly at development, usually by way of joint ventures with local developers, who are often willing to take on partners to obtain better access to foreign capital and technical expertise. Completed assets do exist, however. With most existing stock having been built by domestic developers, there are now opportunities to buy and fix. According to one investor: “There are some questions around standards and design, so it’s probably a value-add play because you’d have to do some sorting out. We’ve just bought an office tower at 7 percent to 8 percent [yield] and a retail podium in a mixed-use development for just under 9 percent.” Opportunities also exist to provide debt financing, given the generally high gearing of many domestic developers.

**Shenzhen (sixth in investment, fifth in development).** At present, yields on office properties in Shenzhen are the lowest in China. At around 3.5 percent, they stand below the yield on the Chinese sovereign bond, raising questions of relative value compared with other Chinese cities, especially in view of a big incoming supply pipeline. Shenzhen assets have seen some of the



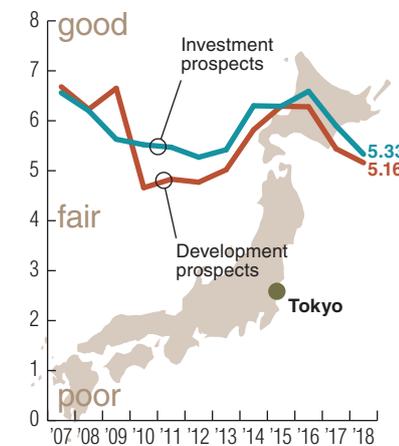
highest capital value increases in the country in recent years.

One reason real estate investors are long-term bullish about Shenzhen is the renewed momentum of the “Greater Bay Area” (GBA) scheme, a government-backed project aiming to create an integrated city cluster from 11 metropolises around the Pearl River Delta—including in particular Shenzhen, Hong Kong, and Macau. While the economic rationale for the GBA has been questioned, there can be no doubt it has acted as a catalyst for significant amounts of new property development, in particular in Shenzhen’s vast 26 million-square-meter Qianhai Free Trade Zone.

Other new sources of demand are various local urban regeneration projects. As traditional core areas of Shenzhen such as Lohou and Futian fill up, attention is morphing to nearby former industrial zones, a process given added momentum by the gradual relocation of many of Shenzhen’s light manufacturing industries either elsewhere in China or into Southeast Asia.

Shenzhen’s residential market was the hottest in China in 2016 but has continued to deflate slowly in 2017, largely as a result of a local government policy (repeated elsewhere in China) requiring downward adjustments of prices at newly developed projects. Strong demand continues for new homes, however, resulting in the overspill being absorbed in neighboring townships. These have again become new sources of development demand.

**Tokyo (seventh in investment, 13th in development).** The rapid rise in rents and asset prices over the last five years has made Tokyo a home run for those who invested in the wake of the introduction of Prime Minister Shinzo Abe’s quantitative easing program in 2013. But the appeal of the rental-growth play has faded more recently as upward



pricing pressures in Japan have run out of steam.

Tokyo’s rise in the rankings this year, therefore, has more to do with the emergence of a new type of yield-seeking investor looking to play the spread between the yield on the property and that available on Japan’s sovereign bond, which currently trades at around zero. The spread is small but seen as a safe and stable way to outperform the alternative—investing in the sovereign itself. As one fund manager said: “Even at these eye-popping low cap rates, you can still get 200- to 300-basis-point spreads over the government bond.”

With office rents stagnant and a looming problem with incoming supply, many foreign investors are now rotating instead into residential assets, which are perceived to be a safer option. As a result, however, competition for stock has increased and residential yields in some cases have quickly declined to less than 3 percent, according to one investor.

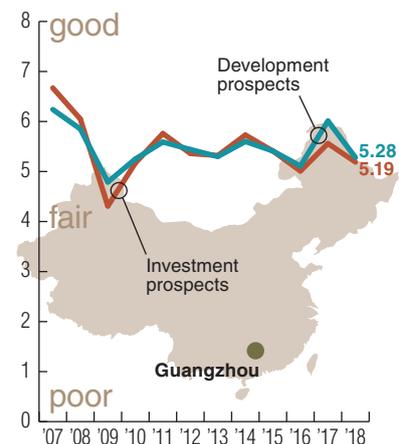
Tokyo is not a destination where foreign investors have traditionally looked to be involved in development plays given high construction costs and a market historically dominated by local developers. This explains Tokyo’s low showing in the development rankings. Times are changing, however. According to one locally based fund manager: “The economics on development now works,

especially for residential—we like it and are now actively looking for development projects because you can build to where rents are. The problem has been in finding available land, partly because there’s no pressure to sell but also because a lot of it has already been built out over the last couple of years. So what we’re buying now are buildings upon completion by small and mid-sized developers.”

**Guangzhou (eighth in investment, tenth in development).**

With office rents in Guangzhou about half those in Beijing and Shanghai, the city remains a (relatively) poor cousin of its northern peers. Nonetheless, solid economic growth means that demand for Grade-A space remains strong. So while vacancies are high (at about 10 percent) and a substantial pipeline of new supply is on the way, the fact that relatively little is being built in core submarkets means there is actually a shortage of available space in the best-quality buildings.

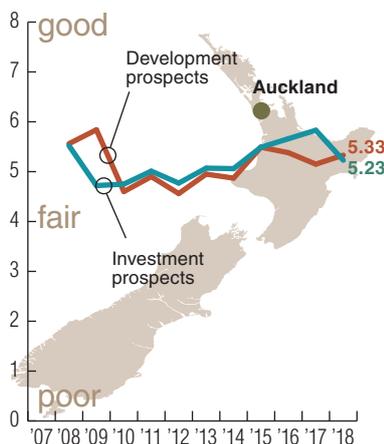
Rental growth for prime properties therefore remains strong, growing at an annualized rate of 6.1 percent year-on-year in the first half of 2017. It is expected to remain strong going forward. Investment activity also has been high in the first half of 2017, although spiking activity represents just a handful of major deals rather than any fundamental change in the market.



Meanwhile, activity in outlying areas is booming, with the government directing its expansion efforts for both residential and commercial properties toward a handful of satellite districts. This has provided opportunities for foreign developers to be involved in building both business parks and residential communities in these areas, linked by train and road both to Guangzhou proper and other cities in the area. One, the Sino-Singapore Guangzhou Knowledge City, is a greenfield master-planned township designed to accommodate around 500,000 inhabitants. Given their scale, these types of projects favor larger investor/developer collaborations. They have become a theme in other major cities in China, too.

**Auckland (ninth in investment, seventh in development).** Apart from scale, New Zealand has many of the same attributes as Australia in terms of investment appeal. Although previously something of a backwater, Auckland has emerged swiftly from the shadows in recent years as investors pursue the generally higher yields on offer.

While office cap rates have now compressed, they remain quite high by Asian standards at around 6.1 percent, according to JLL. With a limited supply of good-quality buildings, office vacancy continues to be tight (less than 1 percent for premium buildings). As a result, Auckland has been targeted by international capital (much of it from

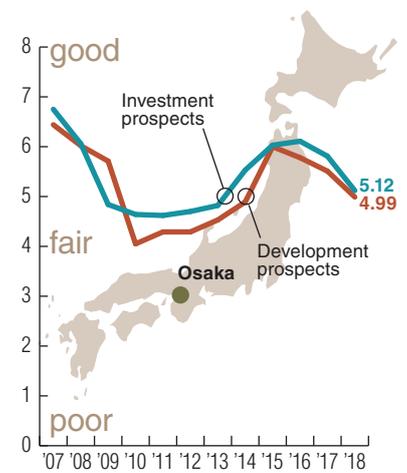


Singapore and China) looking to develop new space, which is now beginning to arrive in earnest. Most of this has been pre-leased, suggesting that demand remains strong. Higher rents for these properties mean that rental growth is continuing, and an emerging market for value-add plays has now been created by rising vacancies in buildings that tenants have recently vacated. The market may take time to digest the new supply, however. According to one locally based broker: "With supply increasing, landlords are more focused on filling space and securing finance as opposed to rental growth."

The New Zealand retail sector also has good prospects given local planning laws that create problems building new shopping centers. Hotels, meanwhile, are a "hot subsector" due to ongoing increases in tourism arrivals, particularly from China.

Residential prices have mushroomed in New Zealand, with housing costs continuing to rise despite new taxes aimed at deterring speculators. Unaffordability is now acute, and the government seems set to introduce rules similar to those in Australia that tighten market access to foreign buyers. In the meantime, opportunities have emerged to build affordable properties, in particular low-rise apartments. Even here, however, efforts have been complicated by soaring land costs that have eroded development margins.

**Osaka (tenth in investment, 15th in development).** Investment in provincial Japanese cities has boomed in 2017 as investors migrate away from Tokyo looking for higher yields and less competition. Osaka has emerged as a favorite play, followed by Yokohama, Fukuoka, and Nagoya. In many ways, Osaka can be considered the poster child for core investors now taking refuge in secondary markets. According to one Tokyo-based investor: "One of the things to keep in mind is that Japan is changing to a service-based economy,



and so if you look at where Osaka is positioned, because of the lower cost of living and much lower overall operating costs compared to Tokyo, it's a great place to be for service-based businesses because you don't have to pay high wages."

Although commercial property investment in Tokyo fell in the first half of 2017, higher inflows to provincial assets mean that overall volumes in Japan rose some 14 percent year-on-year, according to RCA. Buyers now include domestic REITs, which previously refrained from investing outside of Tokyo.

Traditionally, cap rates in provincial cities are some 100 to 200 basis points above equivalent prices in the capital. Yields have compressed significantly, however, and in many cases have fallen below this threshold, with Osaka offices now trading at yields as low as 3.6 percent. Capital values, meanwhile, have increased 18.4 percent and rents 7.1 percent year-on-year in the first half of 2017, according to JLL. This is partly due to rapidly declining vacancy rates, but the reality is that the easy money for this trade has probably already been made. At the same time, declining demand among (especially foreign) investors for Japanese office assets means that investment levels in the sector appear to have plateaued. While some have switched to the residential sector as a result, yields have now also compressed here, leading some to

question the relative value of Osaka residential assets compared with equivalent properties in Tokyo.

**Beijing (11th in investment, 17th in development).** Despite a steady pipeline of newly developed office buildings over the last two years, Beijing continues to show a seemingly unquenchable thirst for new space, partly as domestic companies nationwide continue to establish headquarters in the capital. This means fewer assets trade in Beijing compared with Shanghai. According to one fund manager: “There’s very strong absorption of space for self-use in the market, especially in the financial and tech industries, so it’s very hard to find quality assets that come to market—you’re seeing cap rates going in at sub-4 [percent] in those spaces.”

It also means that fundamentals have remained strong. Vacancies are fairly low (at around 6 percent) and rents have shown only marginal declines from levels that currently make them the second highest in Asia after Hong Kong. Incoming new supply in non-CBD districts (including a long-term plan to relocate more government and private sector offices to satellite cities) will alleviate downtown demand pressure to some extent, but with limited space remaining in the most popular CBD and financial district areas, rents and values there are likely only to increase.

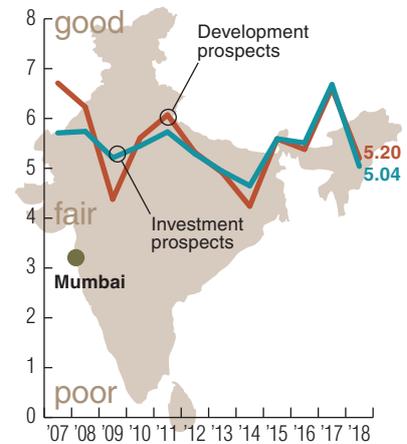


The high amount of aging and mispositioned stock in Beijing has provided new scope for value-add/conversion plays, with many landlords or investors looking to find suitable retail or hotel assets to convert to office space, targeting 30 to 40 percent rental increases as a result.

Stringent conditions set by the government for new land auctions in the capital, including price ceilings for sales prices of finished properties, mean that developers have little prospect of making a good margin (or, at times, any margin) when buying land for residential. As a result, auction prices and land sales have plunged, although there have been several plots that have sold recently at levels that mean developers will necessarily take a loss.

**Mumbai (12th in investment, eighth in development).** Of all India’s major cities, Mumbai is the one least dominated by IT-sector demand. This means it has to some extent missed the opportunity in the business outsourcing boom that has been so apparent in cities like Bangalore. At the same time, Mumbai remains the financial capital of India and so has benefited from the recent strength of India’s capital markets. Absorption has therefore been strong, driven also by demand in coworking, manufacturing, and services companies.

Although steadily declining, Mumbai’s office vacancy rate (at around 17 percent) continues to be very high, and with a pipeline of incoming supply totaling about 40 percent of existing stock, fundamentals would appear to be negative. In reality, however, Mumbai continues to lag behind in term of Grade-A stock, meaning that any new supply is quickly taken up and that rental growth for those properties remains strong. According to one fund manager active in India: “Longer-term, India is going to lead the headlines in supply/demand statistics—it’s a market where relevant supply means much more than total.”



Another sector now drawing increasing foreign investment interest is retail. While Mumbai has a general shortage of good retail space, which therefore creates demand, the question of location is especially important because of the sheer size of the metropolis. According to one fund manager: “There are today maybe five good malls in Mumbai, but to get to locations in the center of town from outlying parts can take two hours, which means many people might as well not go. So, if you get the location wrong, then obviously malls don’t work. It also leads to the belief that e-commerce has to pick up at some point because it’s very difficult for people to go to malls due to the connectivity issues. This means logistics as a sector—and especially with the tax reforms currently going on in India—could be more interesting.”

**Hong Kong (13th in investment, 14th in development).** The low ranking accorded Hong Kong in this year’s survey is once again an indication of the lack of investment opportunity due to high prices and a relatively illiquid market rather than concerns about an impending downturn. In fact, Hong Kong’s ranking this year is several places higher than in the recent past, reflecting a number of factors.

First, there has been a pickup in general investment activity. Although Hong Kong



has historically been a market where very little core stock trades, a number of large transactions made it the biggest investment destination in Asia in the first half of 2017. This has been complemented by a number of very large land purchase transactions in 2017, many involving Chinese developers looking to diversify away from low-margin deals in their domestic market.

On the retail front, there now seems a bottom in sight after several years of declines. As one local fund manager said: “There have been interesting cyclical changes in luxury retail in Hong Kong, which has been absolutely hammered over the last several years, with rents down 40 percent and more—it looks like that might be changing, with sales figures now showing an uptake.”

Another interesting development has been the uptick in interest among foreign core fund managers looking to find value-add investments as opportunities in more active core markets in the region fade. Hong Kong provides good scope for such deals because the rental differential between Grade-A and Grade-B buildings is much greater than it is in other markets. As a result, both foreign and local players are now looking for potential repositioning deals, very often with coworking or co-living potential in mind.

Finally, activity continues to pick up in the secondary CBD area located in east

Kowloon. Quite apart from several large recent office deals in the area, the government has recently indicated interest in reviving a defunct scheme to encourage renovations of former industrial buildings into office or possibly residential assets. This would probably reignite interest in redevelopment plays should it come to fruition.

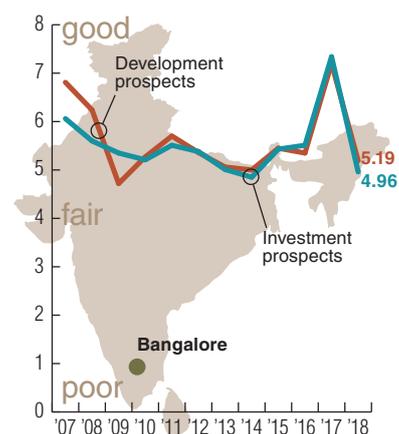
**Jakarta (14th in investment, 12th in development).** Interest in Jakarta office assets has plunged in the past couple of years due to supply concerns. According to JLL figures, vacancies have risen to nearly 30 percent, while rents plunged 11 percent year-on-year in the first half of 2017, continuing a decline that began in 2015. That said, the market has shown itself receptive to new supply, with good buildings close to transportation links having no problem finding tenants. As one local investor put it: “Certain types of tenants need to be in certain types of area, and while there’s been an adjustment, rents haven’t gone down 50 percent. I think most developers will certainly get the occupancy and then it’ll take longer for rentals to recover further down the line.” With incoming supply set to wane beginning in 2018, there may be light at the end of the tunnel.

On the residential side, the high-end market has been hit especially hard, although a handful of new projects in the city center—generally mixed-use—have recently drawn surprisingly strong responses. According to one locally

based investor, this is partly a result of pent-up demand and partly because investors and consumers are looking to buy a particular type of property: “I think firstly location is key, so anything with an infrastructure story looks good, especially if it’s near an LRT [light-rail transit] line. And second there’s the price point, which also means smaller size. So, you’re looking at the smaller one-bed units of 40 to 50 square meters, or comfortably below the IDR5 billion [about US\$370,000] threshold that increases tax by 10 percent.”

Foreign investor interest in the logistics sector—especially that connected with e-commerce—has now increased. Activity will likely continue given the shortcomings of existing infrastructure.

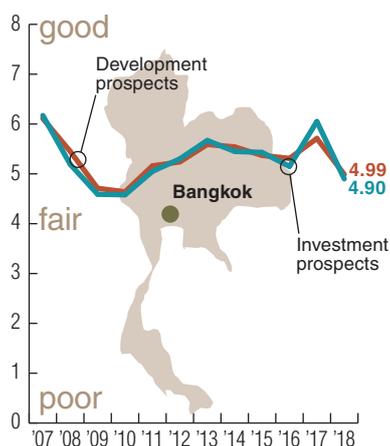
**Bangalore (15th in investment, 16th in development).** India’s emergence as a center for the business process outsourcing (BPO) industry has been led mainly by Bangalore, whose reputation as an IT center acted as a magnet for scores of foreign companies to set up outsourced-service facilities there. Early foreign investors in this sector bought income-producing assets in business parks in conjunction with local partners and scored some major successes. Some of these assets have now been earmarked for sale, in particular via India’s newly emerging REIT sector, which is expected to launch its first IPO in the first quarter of 2018.



Today, operators of BPO facilities in Bangalore have reported rental growth of around 8 to 9 percent annually, together with healthy new tenant demand. Still, Bangalore's BPO story may now be tapering off as the emergence of automation and artificial intelligence technologies creates a long-term drag on demand for back-office and customer service functions globally.

According to one fund manager active in India: "The exuberance of the IT outsourcing to India has gone away and I think you're not going to see 20 percent growth again—maybe you'll get 5 percent to 10 percent growth or even lower. Nowadays, occupiers are the same, but the kind of work being outsourced here is slightly different. There is more cloud computing, more robotics, AI, and that kind of profile of work. Compared to a BPO, they require less space because you can't have 5,000 software developers working on cloud computing, maybe you need 500. So, I think the demand is less, but at the same time it will become more sticky over the long term."

**Bangkok (16th in investment, 16th in development).** Thailand has endured a shaky reputation among foreign fund managers on account of numerous coups and other political crises in recent years. Its economy and real estate markets continue to tick along notwithstanding the problems, however, with both rentals and capital prices trending steadily higher.



Given this, the bigger obstacles for foreign investors looking to buy commercial assets in Bangkok are a shortfall of investable stock combined with a very illiquid market. When assets do trade, transactions have long been dominated by local developers and investors. The same applies to prime land sites, with a relatively small number of new projects in the pipeline. At the same time, there has been increasing activity by capital from Japan, Singapore, and, most recently, China seeking to participate in CBD office projects in partnership with a local player.

Probably the obvious option for international investors in Thailand is the tourist sector, with new arrivals—in particular from China—growing hand over fist. Resorts were the asset class most often mentioned by investors, therefore, together with hotels in the capital.

The other source of potential growth for international investors in Thailand is in the condominium market, especially in Bangkok, with sales to foreigners mushrooming in the last few years. This is providing scope for investments by foreign groups looking to sell their allocated portion of projects to buyers in their home countries. In 2016, around 80 percent of foreign purchases involved buyers in either Hong Kong or China.

Finally, one investor mentioned Thailand as a potential location of retirement communities for a well-heeled clientele.

**China's second-tier cities (17th in investment, 11th in development).** First-tier cities in China tend to suffer less from regular bouts of overbuilding because they continue to enjoy rapid growth as both businesses and workers gravitate toward the largest urban centers. That is not necessarily the case with smaller cities, many of which have been swamped in recent years by enormous gluts of housing and commercial space.

Over the last two years, however, some of these cities have been able



to digest large amounts of excess space. Residential assets have either been sold off at a discount, bought by "spillover" buyers from nearby first-tier cities, or converted by local governments to low-income housing projects. Commercial oversupply has taken longer to deal with, but more and more second- and third-tier cities—interviewees mentioned in particular those along the Yangtze River such as Chengdu, Wuhan, Nanjing, and Hangzhou—have now managed to work their way through surplus commercial stock.

With vacancy rates in these cities falling, second-tier destinations are again working their way back up the rankings, especially on the development side. Some domestic and foreign investors are now increasingly willing to consider selective investments in second-tier cities as competition and prices heat up in first-tier locations.

In addition, as rents and salaries in the big four Chinese cities continue to rise, there is increasing scope to establish service facilities in cheaper locations. As one locally based fund manager said, "Some Tier 2 cities have clearly turned the corner and have bright futures for back-office function and fulfillment centers."

**Manila (18th in investment, 19th in development).** In recent years, office demand in the Philippines has been driven by the phenomenally success-



ful BPO sector. Although growth in this area has slowed, office fundamentals continue to be very strong. Vacancies stand at a low 3 percent, while rent and capital values in the first half of 2017 are up a healthy 5.3 percent and 8.6 percent respectively year-on-year, according to JLL. Land prices, meanwhile, rose between 25 and 33 percent in the most popular areas of the city.

One investor noted the impending relocation of the Philippine stock exchange from Makati to Fort Bonifacio, which “will mean a wholesale change to the shape of Manila. I think it will be like [London’s] Canary Wharf, with the finance guys moving out of Makati where the stock is very old and badly managed to shiny new buildings where currently there is some vacancy. Makati will probably be backfilled with BPOs, so structural change is going to happen.”

To the extent that BPO growth has slowed, the slack has been taken up by new demand from offshore online gaming companies, which are now the second-largest occupier of office space in metro Manila after the BPO sector, according to local brokers Leechiu Property Consultants. One investor questioned whether this was a sustainable trend, however.

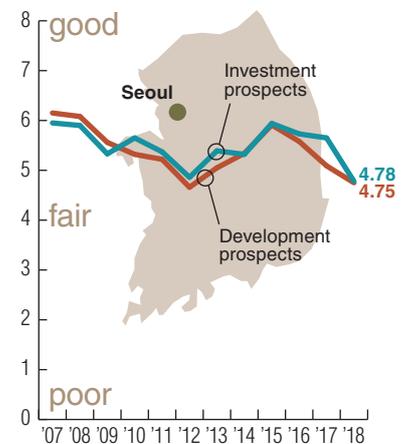
Sentiment among overseas investors has recently been dented by political controversies, an on/off territorial rights

dispute in the South China Sea, and ongoing fighting with insurgents in the south of the country. There seemed plenty of opportunistic funds willing to invest in Manila, however, with one noting there is “definitely demand for more office space” in Manila. At the same time, however, more than one interviewee complained of the difficulties of finding good partners.

Comparing it favorably to investing in Indonesia, one investor said: “I think they [i.e., local developers] generally would love to have a partner and they would be happy to give you the controls that you want and be institutional about it, which I’m not sure most of the groups in Indonesia, for example, would do. That being said—and this is an issue across Southeast Asia, except possibly Vietnam—the returns that local or regional Southeast Asian groups will develop at are pretty low, so on a risk-adjusted basis that makes it a bit challenging. We have the big Filipino groups who’d be happy to develop at 12 percent IRR in the local currency, and it’s kind of hard to justify that.”

**Seoul (19th in investment, 22nd in development).** Despite its lowly ranking (likely due to the current crisis with North Korea), Seoul continues to feature prominently on the radars of many core fund managers in the region, mainly because it trades at yields slightly higher than other Asia Pacific core markets such as Tokyo and Australia. In addition, the yield spread between effective rents (around 4 percent) and the local sovereign bond (around 1.8 percent) is quite wide.

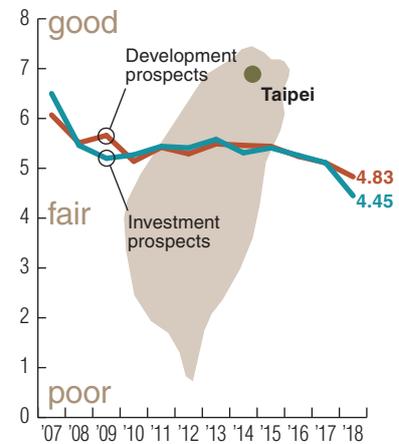
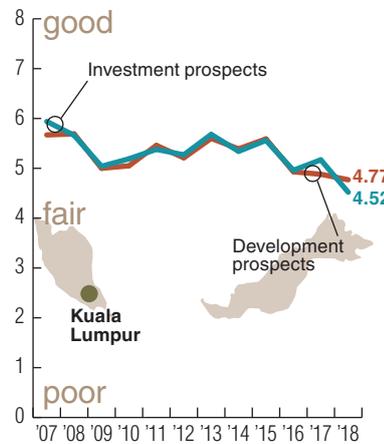
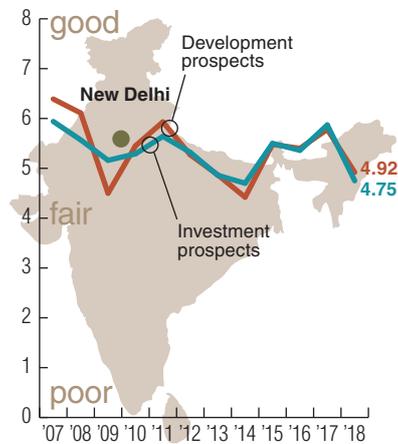
Most investors are focused on buying stabilized office assets, although fundamentals have recently been weak. Value-add strategies are now becoming more popular, a logical move given that much of the local office stock is quite old. However, few foreign investors appear willing to take development risk—a surprising stance given that many are happy to do so in appar-



ently riskier markets such as China. According to one investor, development in South Korea can be a profitable exercise due to dysfunctionalities in the way that construction is financed, which leads to poorly designed stock and a preponderance of strata-title buildings. Build-to-core development is therefore a realistic option because there is a lack of available prime en bloc assets.

Another asset class currently popular in South Korea is logistics, which, according to one analyst, “is like Japan 15 years ago.” The big global operators have been slow to develop in Seoul, meaning that much of the existing infrastructure is aging and of poor quality. Recent new investment in the sector now threatens to create oversupply, but there remains scope to develop for the right type of facility in the right location, given especially that logistics assets in South Korea are currently trading at yields around 100 to 150 basis points above those for offices.

**New Delhi (20th in investment, 18th in development).** New Delhi remains unpopular with investors compared with other major Indian cities. According to one local interviewee, this is mainly due to an emphasis on development in the residential sector, which has recently been in a downtrend. While this has created opportunity to supply bridging finance, not many foreigners have pursued this option.



As a group, northern India developers tend to be overleveraged and are often holding large portfolios of high-end housing, an asset class that is in oversupply. Many projects have been subject to long delays and some developers have acquired poor reputations as a result. In the words of one local interviewee: “Delhi continues to suffer, but that also means for people who understand the story there is greater potential—the moment the [residential] markets turn, Delhi will be one of the first cities to start seeing a pickup.”

In the office sector, Delhi missed its chance to grab a share of the surging growth seen in business parks located in the south. Although there has been some recent demand from IT companies, uptake overall has been slow, leaving office vacancies at an elevated 30 percent, according to JLL. As a result, Delhi has “been a bit on the back foot when it comes to absorption, but in general rentals have been holding firm.” As in Mumbai, however, rents are higher and vacancies lower for prime properties in good locations.

**Kuala Lumpur (21st in investment, 21st in development).** Markets in Kuala Lumpur have remained stagnant over the last year, with oversupply continuing to pose problems given very moderate levels of take-up as multinationals in the oil and gas sector downsize. CBD

vacancy rates have inched up to around 15 percent, according to JLL, and are unlikely to subside any time soon given elevated rates of incoming stock. Rents have so far remained flat, but many analysts expect they will trend downward over the next few years.

As one fund manager observed: “Sentiment among consumers is quite low and a little bit shell-shocked at the moment. There’s just oversupply in everything everywhere you look. It’s a very insular market and I’ve been sniffing around there in the last year to see if there’s a breakout. But not yet. If something isn’t leased up yet, you’ve got massive lease-up risk.”

The same situation applies in the residential sector, where the number of unsold units has continued to rise, leading developers to delay launches. In particular, previously strong demand from Chinese buyers has softened as a result of capital controls imposed by the Chinese government. This has affected in particular the enormous developments now underway by Chinese developers in the southern city of Johor Bahru.

**Taipei (22nd in investment, 20th in development).** Although the government changed the law a few years ago to force Taiwan’s cash-rich insurance companies to invest their capital

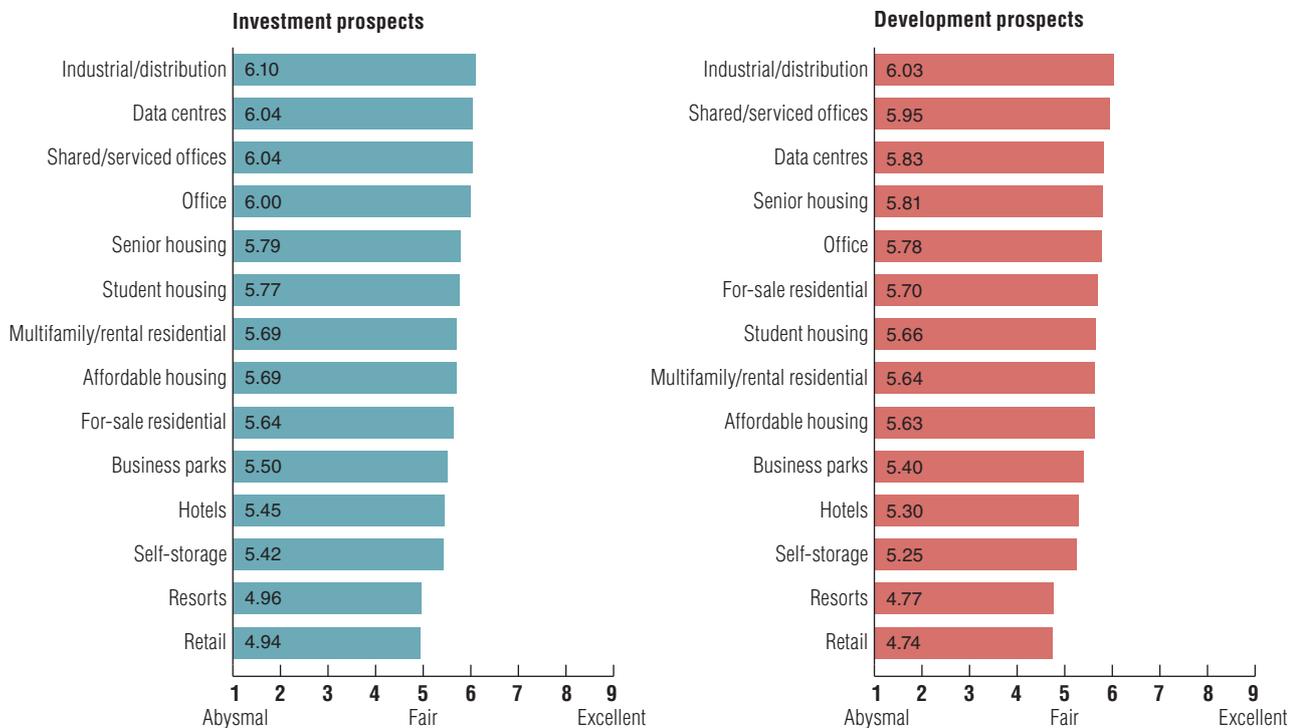
in markets outside Taiwan, the local commercial property market remains captive to institutional owners, with very few assets trading and yields that are some of the lowest in Asia, at around 2.4 percent. Investment activity in the first half of 2017 was 58 percent lower than in the same period of 2016 as buyers refused to accept high asking prices. As a result, most recent activity has focused on redevelopment projects, as insurance companies move to upgrade aging stock.

Foreign investor participation remains minimal, not least because there is very little to buy. That said, there has recently been some pickup in foreign investment in the commercial sector. In particular, a large hotel sale and lease-back acquisition was sealed in late 2017, while an upcoming US\$2 billion project to develop two large mixed-use projects near Taipei Train and Airport-link MRT stations is also expected to involve foreign investors.

The residential market remains weak, although after two years of price declines resulting from higher government property transaction taxes, it may now have hit a bottom. Sales volumes are increasing, prices have inched up, and land transactions also have improved as developers begin to add to land banks. That said, affordability remains a major issue.



Exhibit 3-4 Prospects for Commercial Property Types in 2018



Source: Emerging Trends in Real Estate Asia Pacific 2018 survey.

## Property Types in Perspective

### Office

The office sector continues to be the go-to option for most investors, although to a certain extent the shine has come off this year as more fund managers come to the conclusion that rental growth is slowing regionally. That’s a problem for a couple of reasons. First, because with yields so low it implies capital values may have hit a ceiling too. Second, because those same low yields mean leverage is no longer playing a big part in boosting returns. In markets such as China and Hong Kong, for example, the spread between the asset yield and the borrowing cost is now minimal, which means, as one fund manager said: “In order to get superior returns, you’re not getting any benefit from the leverage; it’s all about the rental growth you’re able to generate out of the asset.”

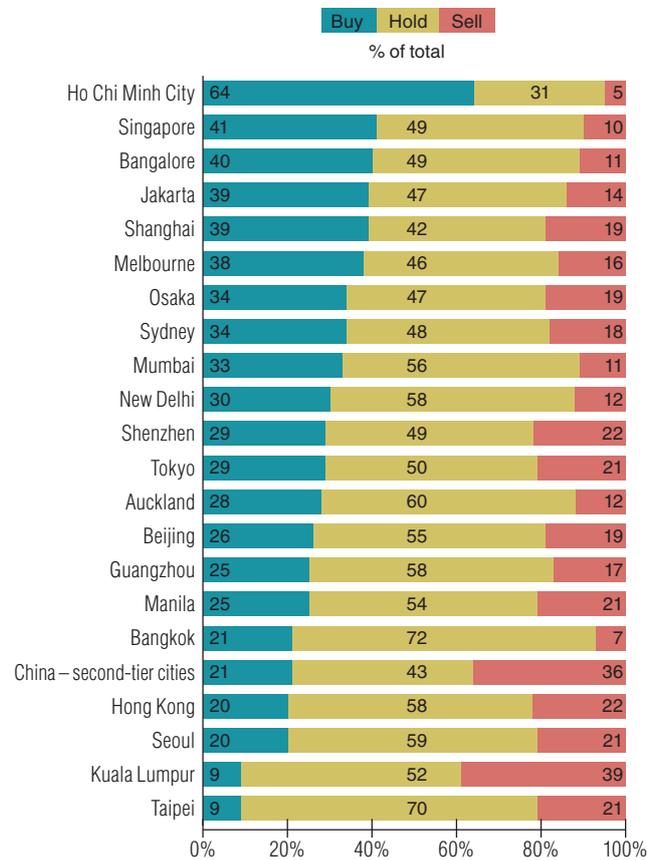
Opinions on rental growth prospects were quite polarized, however, with many investors convinced that rents will continue to rise, at least in many markets. While they are expected to flatten in Tokyo, therefore, rents in Australia are projected to see strong growth. Investments in developing markets have also been predicated on the basis of steadily rising rents. The balance of opinion therefore lies somewhere in the middle. As one investor said: “The overall supply/demand situation is still quite favorable for landlords; so while rental growth may not

be what it was in the past seven years, it should still continue at a lower level.”

**Expected best bets:** With GDP growth soaring amid a structural undersupply of office space, Ho Chi Minh City is now a focus of attention. But predicting growth is one thing, profiting from it is another. One foreign investor spoke of buying finished assets in Ho Chi Minh City at a 7 to 8 percent yield, with a view to upgrading them as a value-add play. In reality, though, the acute shortage of investable stock in Vietnam makes development the more realistic option, though even here pickings are thin. That said, local developers remain open to partnering with foreign capital, and there is also scope for providing debt to Vietnamese developers who as a group are generally short of cash.

Singapore has shot up the office rankings this year as investors anticipate a rebound in a market that has been in decline for several years. Although some remain skeptical that fundamentals in Singapore are really improving, the balance of opinion was summed up by one fund manager, who said: “Singapore tends to be quite cyclical. Rents have come off 20-something percent since the peak in this current cycle, so we think we’re now at the bottom, and that suggests rental growth going forward for a couple of years.”

**Exhibit 3-5 Office Assets Buy/Hold/Sell Recommendations for 2018, by City**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

Shanghai's strong showing is something of a surprise given the way prices have mushroomed (offices now trade at sub-4 percent) as local institutions rush to place funds regulators have barred them from deploying internationally. Some foreign investors said they were now sitting on their hands watching the action, but more than a few others have a mandate to deploy major amounts of capital in Shanghai and are now moving to do so, irrespective of the squeeze. Given the overall weight of money looking to buy in China—both foreign and domestic—cap rates seem likely to remain under pressure for the foreseeable future.

Of the two major core markets in the region, sentiment for Australian offices is predictably strong given expectations for ongoing rental growth (with the caveat that actually placing capital is now harder than ever), while Tokyo's improved showing from last year's mid-table ranking is the result of a changing of the guard—less activity by rental growth capital and more from safety-seeking institutional and private capital. These yield-driven investors are happy to buy Tokyo office assets that are tightly priced (at sub-3 percent) but still enjoy

a positive spread in terms of both the yield on the local sovereign bond and the cost of borrowing, which allows them to boost returns by adopting a degree of leverage. As one fund manager observed: "Japan is one of the largest savings markets on the planet and if your risk-free return is negative, you lose money by keeping it with the bank, so very modest levels of income return then become extremely attractive."

## Residential

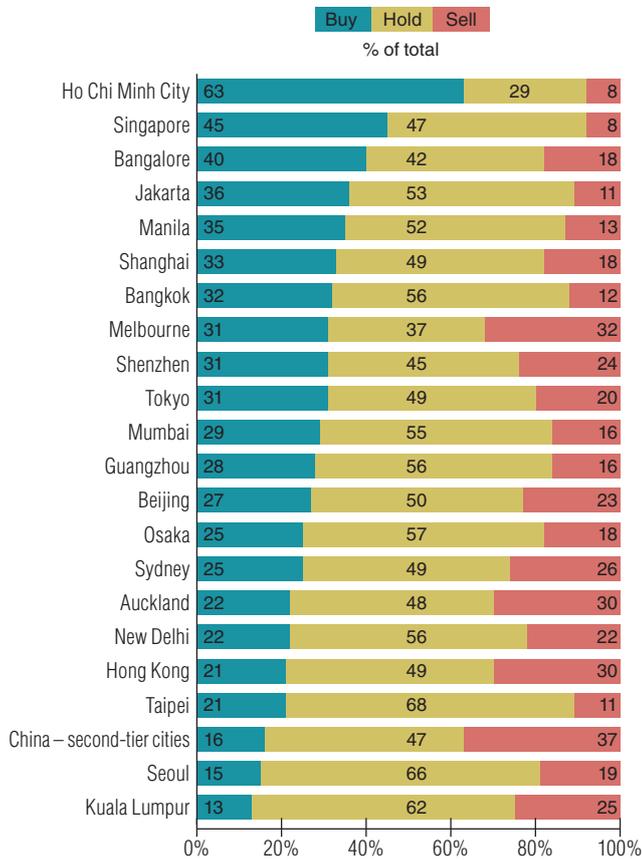
Prospects for investment in residential assets tend to vary by market depending on individual circumstances. In China, for example, margins have declined from some 20 to 30 percent margins ten years ago, to 0 to 5 percent today. This is one reason for the ongoing exodus of Chinese developers to international markets, where development yields are usually significantly higher. Sentiment also varies according to the impact of government efforts to curtail surging home prices—these are now becoming important in Australia and New Zealand and have been a factor for several years in other markets from Taiwan to Singapore to Hong Kong and to China.

This year has also seen a rising supply of build-to-rent properties arriving in Asian markets (apart from Japan, where they have long been popular). While these are different from the traditional Western multifamily model in that individual units in Asia tend to be much smaller and to focus on a younger demographic, they are likely to emerge as a long-term theme because home prices have now moved out of reach for so many people in Asia, leaving them no choice but to rent.

**Expected best bets:** Given the shortage of existing commercial assets in Vietnam, foreign investors are looking instead at the residential sector, where demand is both strong and growing. The first batch of investors entered the market as long as ten years ago and endured a torrid time, but are now reaping the rewards as they exit. According to one such investor: "Having had a difficult seven or eight years, everything has come good—we're selling sites for 50 percent to 60 percent above NAV. People are just prepared to pay, if you like, tomorrow's price to get good sites."

This tells the story of both the long-term nature and the bust-to-boom dynamics of the market in Vietnam (and, indeed, developing markets generally), where today "things are looking rather frothy, especially in the condominium market, where there are signs of oversupply." According to one investor: "Because a lot of people are wandering around with a lot of cash, the prices have gone sky high and that's hard to justify. They're anticipating a lot of future growth, but when you start to compare the rentals against somewhere like Bangkok, which has a much larger economy, they're higher and they shouldn't be, because there's a relativity to the size of your economy, and the income of your people, and how much they can afford to spend on property."

**Exhibit 3-6 Residential Assets Buy/Hold/Sell Recommendations for 2018, by City**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

The Singaporean story on the residential side mirrors that of office—the market has seen a prolonged downturn but has possibly now bottomed, helped on its way by a partial lifting of government cooling measures. This does little to help investment funds, however, because extra costs in the form of applicable stamp duties are a drag on returns.

Otherwise, residential markets in Melbourne and Sydney rank reasonably high, reflecting the ongoing upward spiral in Australian home pricing. Although home values in both cities appear to have plateaued for now, demand from both foreign and domestic sources remains very strong, and it remains to be seen whether government attempts to stem the tide by taxing purchase transactions will be any more successful in Australia than they have been in many markets across Asia.

Finally, Tokyo residential assets have seen a surge in interest among investors who are now fleeing the office sector looking for a more stable source of returns. Tokyo multifamily has historically always provided this and will probably continue to do so whether or not it generates rental growth, an issue on

which investor opinions vary. However, with yields currently averaging around the 4 percent mark, unlevered returns on Tokyo residential are at least 100 basis points better than they are for office assets, which makes for appealing returns given Japan's low cost of debt. As one fund manager said: "Unlevered returns look awfully expensive. But when you borrow at less than a point, all of a sudden you've got a 6 percent cash flow net of everything, and you can't buy that anywhere around the world."

## Retail

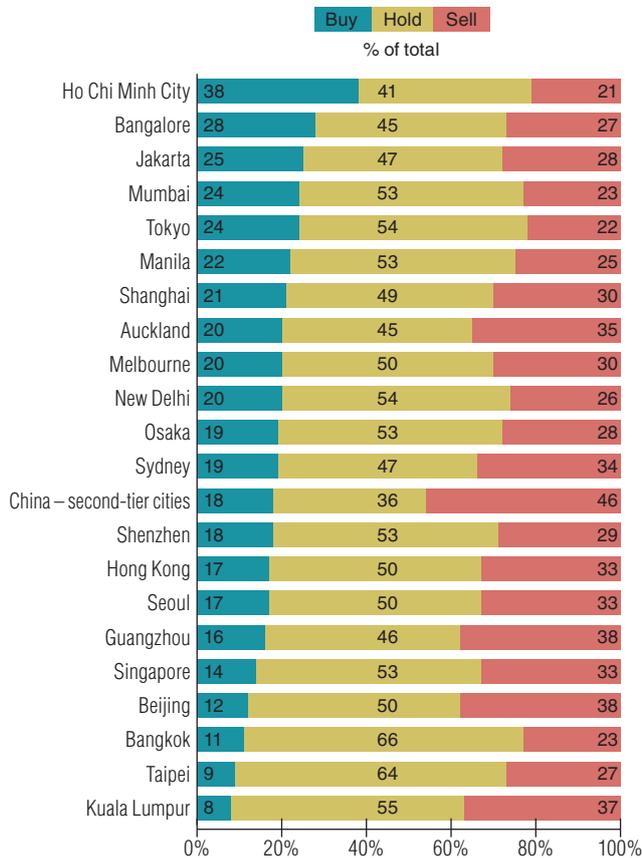
As the challenge posed by e-tailers to Asia's conventional retail malls continues to grow, owners and investors are casting around for strategies that will ensure existing assets remain profitable. Perhaps unsurprisingly, retail featured last in our rankings for commercial property prospects.

Opinions among interviewees, however, were divided. Some saw the threat as existential unless retailers changed business models and updated what they were able to offer consumers from an experiential point of view, noting that many retailers had not sufficiently evolved their offerings and anyway didn't understand what consumers really wanted. As one Australia-based interviewee said: "There appears to be a reluctance to go out and talk to customers and spend time watching what they do and what their habits are."

Others saw Asian malls as already differentiated from the department store-anchored model commonly found in the United States, with many already moving to adopt higher levels of food and beverage or entertainment offerings. In addition, they pointed out, as the ongoing migration of Asian populations to the cities continues, demand will persist for neighborhood facilities selling nondiscretionary items that are not so threatened by e-commerce sales. In addition, uptake of new technology such as heat mapping—whereby malls follow consumers' progress around malls via wi-fi connections on smartphones—is also helping landlords squeeze better efficiencies from existing facilities.

**Expected best bets:** Once again, Ho Chi Minh City tops the rankings. However, while the steep growth trajectory of Vietnamese consumer spending will doubtless continue (official statistics show retail sales growth of 11 percent year-on-year in the first nine months of 2017), both Vietnam in general and Ho Chi Minh City in particular have an oversupply of retail assets, with the latter more than doubling the floor area of shopping center space in 2015–2016, according to CBRE. A huge pipeline of incoming supply—some 500,000 square meters' worth—is also set to arrive over the next three years, once again more than doubling existing supply. Such as they exist, major opportunities in the retail space have tended to fall to the large integrated developers from Singapore and Hong Kong.

**Exhibit 3-7 Retail Assets Buy/Hold/Sell Recommendations for 2018, by City**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

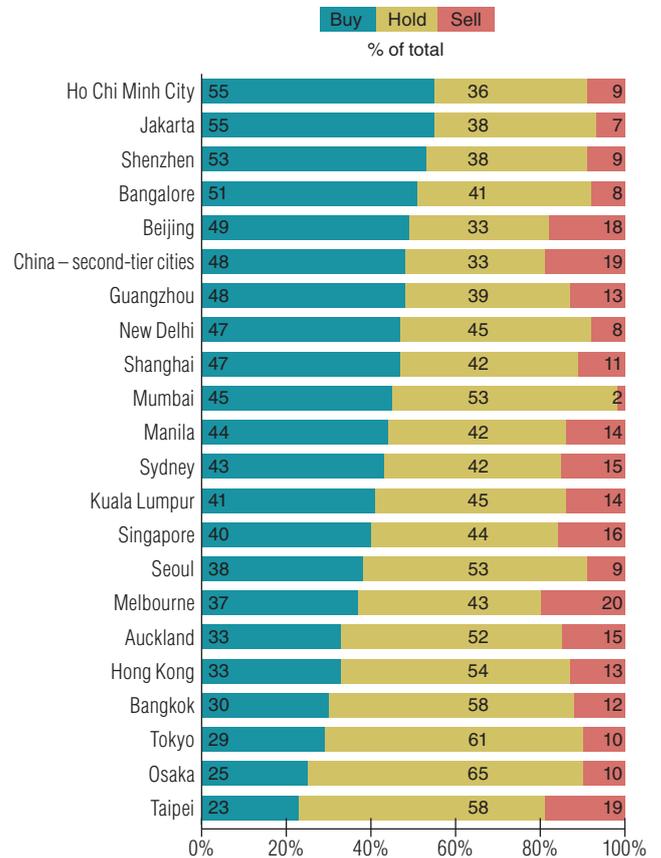
Meanwhile, Shanghai also has moved strongly up the rankings. It is probably fair to say that while China in general has many poorly conceived and performing malls, it is also moving quickly to embrace new technologies and retail formats as it adapts to the threat posed by exponential growth of internet retailers. Nowhere is this more so than in Shanghai, which in some ways has become something of a testing ground for how malls can adapt to e-tailing pressure.

Finally, the upward progress of Hong Kong from its low position last year is also noteworthy, likely reflecting the rebound of a sector hard hit—at least at the high end—by the steep fall in Mainland tourists visiting the city.

### Industrial/Distribution

As exhibit 3-4 shows, survey results confirm that investors continue to see industrial/distribution assets as the most appealing of all commercial property types. Most activity is occurring in China, Australia, and Tokyo. Across the Asia Pacific, transactions hit US\$61 billion in the first half of 2017, up from US\$54 billion in the same period of 2016, according

**Exhibit 3-8 Industrial/Distribution Assets Buy/Hold/Sell Recommendations for 2018, by City**



Source: *Emerging Trends in Real Estate Asia Pacific 2018 survey.*

to JLL. Many of the big players are developing portfolios of assets, while others are acquiring facilities piecemeal.

Demand reflects ongoing structural undersupply across the region, especially as e-commerce sales continue to grow and as evolving retailing models at brick-and-mortar stores cause them to hold goods at warehouses rather than in-store. There is now increasing demand for facilities with modern designs such as multiple entrances and floors, together with inner-city facilities that can cater to last-mile deliveries—probably the hottest growth area in the sector today.

According to one fund manager: “There are a number of people looking at the sector, so there’s no shortage of competition, but the supply/demand dynamics for contemporary modern logistics in Asia still seems pretty good, and my guess is that it’s got legs.” And in the words of another: “One of the things we like about logistics is that the build cycle is short. Compared to a conventional building where it’s a four-year build plan, logistics tends to be a 12-month build cycle and we like that because the market can then correct quickly

by cutting off supply, whereas if it's a big multiuse you'll still be delivering for the next four years."

**Expected best bets:** Shenzhen has retained its top ranking from last year. In addition, most other Mainland cities also feature strongly, with development pipelines across China bigger than all the rest of Asia put together by an order of magnitude, according to CBRE statistics. Chinese demand is so high for a number of reasons: the sheer size of the country and its economy, the previous lack of any modern facilities, the government's longstanding infrastructure buildout policies, and extremely fast growth in its e-commerce industry.

That said, logistics investments in China are hard work on a number of fronts and tend to be the preserve of larger institutional players. One Singapore-based REIT manager suggested that the difficulties of trying to build a China-based platform were such that he preferred to invest in Australia, where investors benefit from freehold property rights, longer leases, and less government interference, among other things.

Japan is another market dominated by the major logistics players. Although many new assets have already been created, opportunity still exists. According to one institutional investor currently looking at the Japanese market: "Despite being a developed nation, the existing facilities are not fully automated or modern, so there's a transition that's ongoing. And Japan is still undervalued. Especially if you're willing to take some development risk, it's probably the least risky place in the world because there are guaranteed minimum price contracts. So, your yield-on-cost is probably 6 percent to 7 percent, versus buying a logistics asset at 4 percent. If you then sell at 4 percent, it's still a good value-add type of investment. A lot of people are ahead of us in this game, though."

According to Deutsche Asset Management, total returns for the three main Asia Pacific logistics markets were 8.7 percent and 8.4 percent for Shanghai and Beijing respectively, 8.3 percent and 7.9 percent for Melbourne and Sydney respectively, and 5.7 percent for Tokyo.

Another interesting destination for logistics, though it did not feature prominently in our survey, is India, where the introduction of a new tax structure in place of the older dysfunctional system has removed inefficiencies and opened up the logistics sector to be developed across the country. This has unleashed a torrent of incoming investment. According to one locally based consultant: "In the last six months, we have seen almost two-and-a-half-plus billion dollars of foreign money flowing to the Indian warehousing and industrial real estate development story, with more coming. And that's just from the top five or six names." With domestic warehousing stock in India currently equivalent to around 1.5 percent of what is available in China, and cap rates currently in the area of 9 to

10 percent, the investment landscape has something of a gold-rush feel to it.

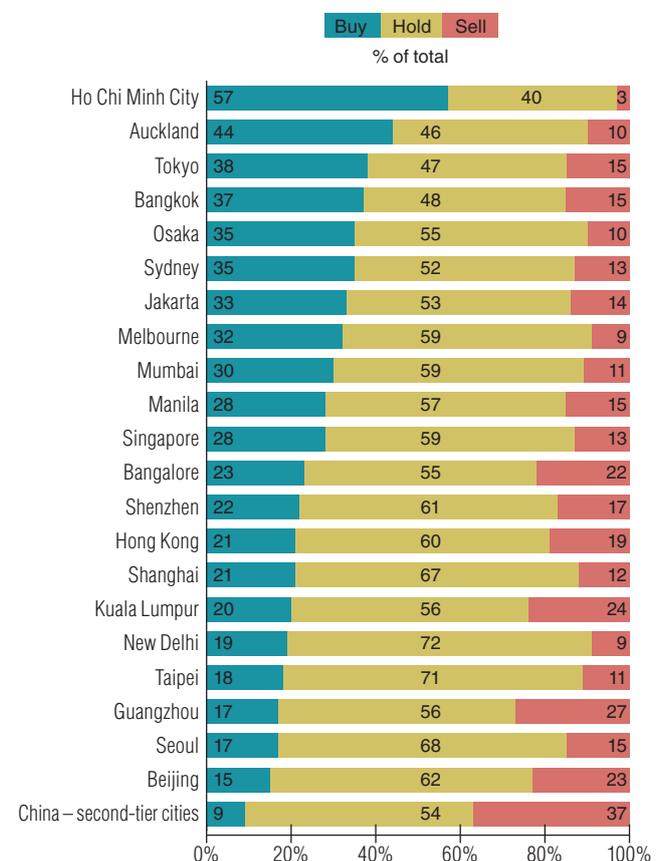
### Hotels

Transactions throughout the region remained reasonably strong in the first half of 2017, led by Hong Kong, which claimed five major transactions totaling some US\$1.6 billion. Activity was driven mainly by domestic buyers. Australia was also a stand-out in terms of hotel transactions during the first half.

Probably the main trend influencing overall activity in Asia's hotel sector is demographic change, with huge annual increases in new tourists traveling internationally as more workers rise above hand-to-mouth existences. This shift is being led mainly by China. The resulting opportunities are being pursued by private equity capital both big and small.

In particular, family funds tend to be drawn to the boutique hotel end of the sector, particularly in Southeast Asia. According to a manager at one such fund: "In our hotels, the guest profiles have changed. In the past, we were looking for corporate clients who paid group rates; but going forward,

**Exhibit 3-9 Hotel Assets Buy/Hold/Sell Recommendations for 2018, by City**



Source: *Emerging Trends in Real Estate Asia Pacific 2018* survey.

banks have been under pressure and corporate accounts have been cut. At the same time, though, we are also seeing big growth in the leisure sector. So that guy in our lobby wearing a T-shirt is probably paying more than the guy in the suit.”

Another fund manager said: “Very wealthy people are traveling, but also vast numbers of first-time travelers [who] are much more interested in the two- and three-star market. They want something clean, safe, and reliable, but they want to spend most of their money on the travel experience and not the hotel. So, we’re bullish on the two- and three-star market in major destinations such as Japan, China itself, Singapore, and Hong Kong.” Australia also was repeatedly mentioned as being able to capture the outbound Chinese demographic.

**Expected best bets:** While Ho Chi Minh City again wins the plaudits in our rankings, the tiny amount invested in the hotel sector throughout all of Vietnam in the first half of 2017 (i.e., around US\$20 million, according to CBRE) is perhaps the best indicator of the real size of the opportunity available there (although admittedly the nearly US\$250 million invested in 2016 paints a rosier picture). Foreign investor interest has been strong, and yields are generally high.

Of the major markets, Australia—and in particular Sydney—continue to draw new investment. According to one investor: “Australia has a good weight of demand—occupancies are in the mid- to high-80 percent range. So demand is actually getting constrained and yet there hasn’t been a new hotel built in the financial precinct for 20 years. Values are now above replacement cost and we see an opportunity to develop.”

Finally, Japan has seen a surge in Chinese tourist arrivals over the last few years, with inbound arrivals rising an impressive annualized 17.3 percent in the year through May 2017, according to government figures. Though Tokyo has been the main destination in the past, Osaka is now also growing in popularity, as are ski resort areas in Hokkaido. According to one locally based investor: “We are looking at some resort residences around skiing areas up north, because there’s strong demand for resort-type stuff in Niseko coming in from foreigners, especially from other parts of Asia.”

The incoming Chinese demographic has driven a significant and ongoing rise in Japanese room rates and revenue per available room (RevPAR) in all these locations. At the same time, there is now a significant pipeline of new supply in the works (at least partly to cater to demand from the upcoming 2020 Summer Olympics in Tokyo). While that causes some concern given how quickly Chinese tourists’ tastes are prone to change, so far there is no sense arrivals are set to decline.



Set against an urban landscape of concrete, steel, and glass in Tanjong Pagar, Singapore's central business district, Oasia Hotel Downtown stands out with its distinctive siren-red silhouette clad in lush greenery. An integrated hotel/office development comprising a 27-story, 314-room business hotel and 100 new-age offices, Oasia Hotel Downtown is one of the winners of the 2017–2018 ULI Global Awards for Excellence.

# Interviewees

**AD Investment Management Co., Ltd.**

Kenji Kousaka

**AEW Capital Management**

David Schaefer

**Ale Property Group**

Andrew Wilkinson

**Allianz Real Estate**

Rushabh Desai

**AMP Capital**

Tim Nation

**Angelo, Gordon International LLC**

Jon Tanaka

**Aoyama Realty Advisors Inc.**

Haruyuki Shinya

**Ascendas-Singbridge**

Jonathan Yap

**Asia Pacific Land Ltd.**

Simon McDonald

**Asterisk Realty & Placement Agency**

Yukihiko Ito

**AXA Real Estate Investment Managers**

Frank Khoo

**AXA Real Estate Investment Managers**

**Japan KK**

Yoshihiko Hayafuji

**Bank of America**

Ben Boyd

**Bestland Co. Ltd.**

Shigeaki Shigemasa

**BlackRock Investments**

Hamish MacDonald

**BlackRock Japan Co. Ltd.**

Chris Handte

**Blackstone**

Chris Tynan

**B-Lot Company Ltd.**

Makoto Miyauchi

**Brookfield**

Dev Santani

**Brookfield Asset Management**

Niel Thassim

**Brookfield Property Group**

Stuart Mercier

**Cache Logistics Trust**

Daniel Cerf

**Capbridge Investors K.K.**

Kenneth Fridley

**CBRE**

Henry Chin

**CBRE Global Investors**

Richard Price

**CBRE Global Investors Japan K.K.**

Tetsuya Fujita

**CBRE Research**

Brent McGregor

**Charter Hall**

Sean McMahon

**Chongbang Group**

Henry Cheng

**Clover Advisors Company**

Takeshi Endo

**Colliers International**

John Kenny

**CRE REIT Advisers, Inc.**

Tsuyoshi Ito

**Daiwa House Industry Co., Ltd.**

Tetsuo Suzuki

**Daiwa Real Estate Asset Management Co. Ltd.**

Akira Yamanouchi

**Deutsche Bank**

Geoff Crum

**Dexus**

Ross Du Vernet

**Diamond Realty Management Inc.**

Takashi Tsuji

**ES-CON JAPAN Ltd.**

Takatoshi Ito

**Farpoint**

Dougie Crichton

**Fife Capital**

Allan Fife

**Fortress Investment Group**

Akio Yamashita

**Fukuoka Realty Co., Ltd.**

Etsuo Matsuyuki

**GenReal Property Advisers**

Ankur Srivastava

**Goldman Sachs Asset Management Co., Ltd.**

Katsuhiko Ishikawa

**The GPT Group**

Matthew Faddy

Nick Harris

Bob Johnston

**GreenOak Investment Management K.K.**

Dan Klebes

**Hulic Co. Ltd.**

Yoshito Nishikawa

**Ichigo Investment Advisors Co. Ltd.**

Wataru Orii

**IDERA Capital Management**

Harumi Kadono

Ryota Nagao

**Ingenia Communities**

Simon Owen

**Invesco Global Real Estate Asia Pacific Inc., Japan Branch**

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**Japan Post Bank Co., Ltd.**

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**Japan REIT Advisors Co., Ltd.**

Ikuo Yoshida

**JLL**

Richard Fennell

Megan Walters

**JPMorgan Asset Management (Japan) Ltd.**

Tetsuya Karasawa

**Kenedix**

Taisuke Miyajima

Takahiro Uchida

**Keppel Capital**

Christina Tan

**Knight Frank**

Alan Liu

**LaSalle Investment Management**

Ian Mackie

**Lendlease**

Tarun Gupta

**Mapletree Investments Japan K.K.**

Norihiro Matsushita

**Marubeni Asset Management Co. Ltd.**

Tetsuo Saida

**Mirvac**

Susan MacDonald

**Mitsubishi Corp.–UBS Realty Inc.**

Toru Tsuji

**Mitsubishi Estate Co. Ltd.**

Tetsuji Arimori

**Mitsubishi Jisho Investment**

**Advisors, Inc.**

Masaki Sakagawa

**Mitsui Fudosan Investment Advisors, Inc.**

Motomitsu Morimoto

Shuji Tomikawa

**Mori Building Co. Ltd.**

Hiroo Mori

**PAG Investment Management Ltd.**

Naoya Nakata

**Pamfleet**

Andrew Moore

**PAYCE**

Brian Bailison

**PGIM Real Estate**

Benett Theseira

**Pontiac Land Group**

Kwee Wei-Lin

**Professional Property Services Ltd.**

Nicholas Brooke

**Property Council of Australia**

Ken Morrison

**Propertylink**

Stuart Dawes

**Quraz**

Stephen Spohn

**Savills China**

James Macdonald

**SC Capital Partners**

Andrew Heithersay

**Sekisui House REIT**

Junichi Inoue

**Shanghai University of Finance and Economics**

Chen Jie

**Shimao Property Holdings Ltd.**

Feng Ke

**Shopping Centres Australia**

Anthony Mellows

**Soilbuild REIT Management Pte. Ltd.  
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Space REIT)**

Roy Teo Seng Wah

**Standard Chartered Bank**

Brian Chinappi

**Starr International Investment Advisors  
(Asia)**

Alison Cooke

**Takara Leben Co. Ltd.**

Yoshitaka Tejima

**Third Shift Enterprises**

Jane Lloyd

**Tokio Marine Asset Management Co. Ltd.**

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**Tokyu Land Capital Management Inc.**

Yutaro Tanaka

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**Blackstone Group**

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The extraordinary impact that ULI makes on land use decision making is based on its members sharing expertise on a variety of factors affecting the built environment, including urbanization, demographic and population changes, new economic drivers, technology advancements, and environmental concerns.

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Front cover photo: The Cutaway at Barangaroo Reserve, Sydney, Australia. The project re-creates a historic headland on an abandoned dock in Sydney Harbor. A team led by ULI J.C. Nichols Prize for Visionaries in Urban Development laureate Peter Walker designed a focal open space including pedestrian and bicycle pathways, as well as this underground cultural center as part of the long-term vision for the area.

Image: Courtesy of Barangaroo Delivery Authority.

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- Reports on how the economy and concerns about credit issues are affecting real estate.
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