UBS

August 2016

APAC Real Estate Outlook.

2H16

Investment opportunities and strategies linked to broad structural shifts across the APAC region likely to outperform

APAC domestic demand drivers remained resilient in 2Q16, supported by further monetary easing, relatively healthy jobs markets and the ongoing structural shift towards services sector production. The latter is being driven by changes in consumer preferences, improvements in technology, wage growth (in emerging markets) but also lower global growth. Weaker trade volumes as a result of slower global growth, increasing trade restrictions and lack of significant liberalization agreements in recent years means that Asia's historical drivers of capital spending and exports have taken a back seat to services based consumption and jobs.

The intense pressure on costs is also driving the corporate sector to cut back on capital spending plans and focus on efficiency gains to maintain dividend payments. The focus on maintaining payout ratios is linked to broad demographic shifts taking place in the region and across the world with a greater share of the households moving into retirement where they rely on their pensions and accumulated wealth to meet current spending needs.

The corollary of the pullback in capital spending is that jobs growth remains relatively healthy despite the weaker growth environment as corporates take on more (flexible and part time) labor to meet output targets. The labor-intensive nature of the services sector vis-à-vis industrial production and manufacturing also supports overall jobs growth. Importantly, these broader shifts are driving changes in end-user demand for commercial real estate space with relative winners and losers between and within sectors across the APAC region.

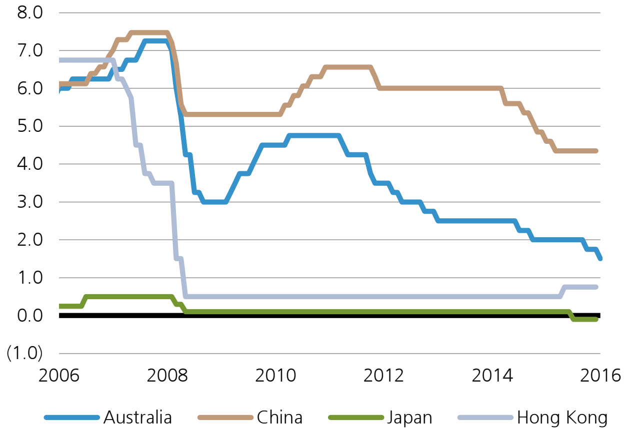
Although property yields across the APAC region are at, or close to, historical lows, demand for real estate exposure in a multi-asset context is set to remain healthy in the near-to-medium term. Capital inflows into the asset class will continue to be supported by broad structural shifts across the region related to demographics and demand for income producing assets on the one hand, and (ex-ante) excess supply of private (household and/or corporate) sector savings on the other. Part of this excess savings will continue to find its way into real estate, both in APAC and in other regions (or is gradually finding its way into private real estate as in the case of Japan).

APAC Real Estate

APAC domestic demand drivers remained resilient in 2Q16 supported by further monetary easing, relatively healthy jobs markets and the ongoing structural shift towards services sector production. The latter is being driven by changes in consumer preferences, improvements in technology, wage growth (in emerging markets) but also lower global growth. Weaker trade volumes as a result of slower global growth, increasing trade restrictions and lack of significant liberalization agreements in recent years means that Asia's historical drivers of capital spending and exports have taken a back seat to services based consumption and jobs.

Chart 1: Further monetary easing across APAC

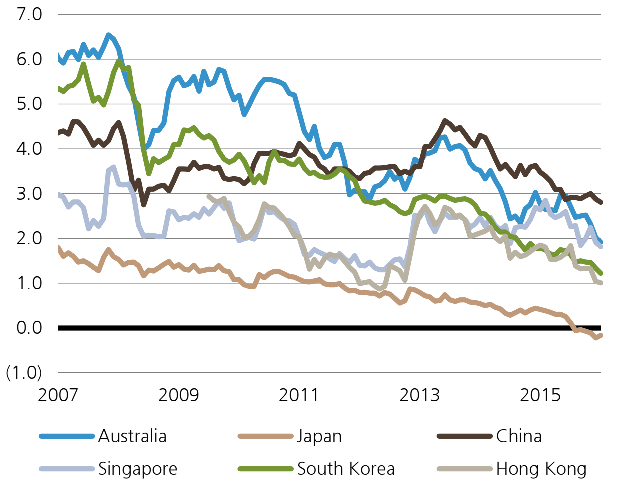
(in %)



Source: Datastream, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

Chart 2: Declining 10-year government bond yields

(in %)



Source: Datastream, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

The intense pressure on costs is also driving the corporate sector to cut back on capital spending plans and focus on efficiency gains to maintain dividend payments. The focus on maintaining payout ratios is linked to broad demographic shifts taking place in the region and across the world with a greater share of the households moving into retirement where they rely on their pensions and accumulated wealth to meet current spending needs.

The corollary of the pullback in capital spending is that jobs growth remains relatively healthy despite the weaker growth environment as corporates take on more (flexible and part time) labour to meet output targets. The labor-intensive nature of the services sector vis-à-vis industrial production and manufacturing also supports overall jobs growth. Importantly, these broader shifts are driving changes in end-user demand for commercial real estate space with relative winners and losers between and within sectors across the APAC region. On account of rising online sales and increasing imports, demand for modern logistics space is set to remain healthy across the APAC region. Third-party logistics providers and retailers continue to seek well-located distribution units near major ports, railways and artillery roads. Demand for smaller infill space is also set to remain healthy, particularly in larger cities where there is growing demand for same/next day delivery, and it is timely and cumbersome to transport goods directly from wholesalers to end-users, including retailers. Rising supply levels may constrain overall rent growth in the sector but occupancy levels should remain relatively healthy in the near to medium term. In contrast, with manufacturing production and exports remaining weak, the traditional industrial sector will continue to struggle across the APAC region.

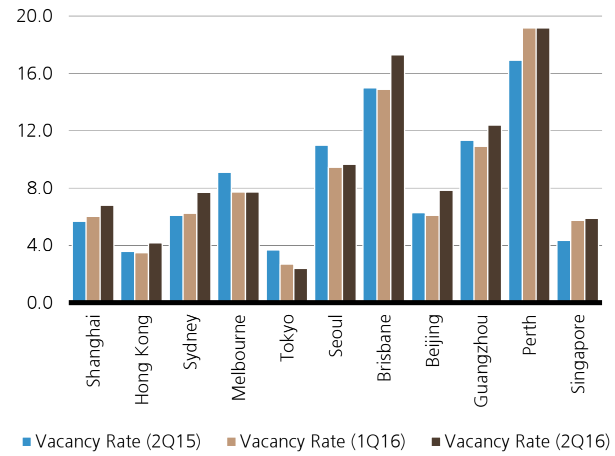
The retail sector also remains polarized across markets, cities and segments, albeit with the additional headwind from rising online sales, which is hitting demand for space from certain retailer segments such as the electronics sector and certain retailer types, such those department stores with outdated shopping concepts. Overall, demand for prime and CBD retail space remains healthy in key cities and markets in Japan, Australia and South Korea supported by inbound tourists and strong demand from food and beverage providers in key office hubs. In contrast, demand from luxury retail space remains weak in the Hong Kong and Singapore markets on account of sluggish demand from inbound tourists and affordability constraints – related to high rents and/or constraints on labour supply as in Singapore – which is squeezing margins.

An increasing concern for the inbound consumption theme in Japan – at least in the near term – is the combined impact of a stronger yen and higher tariffs imposed on goods taken back to China. The latest figures (as of July 2016) suggest that overall tourist numbers have slowed from 31.7% year-on-year (YOY) growth in March 16 to 15.3% in May 16. Importantly, spend per tourist has fallen in recent months and there has been a shift away from high-value electronics and accessories to cosmetics and pharmaceutical goods. Looking ahead, the upside for prime retail performance in Japan is likely to be limited in the near term given the sharp rise in rents has squeezed retailer margins.

In the office sector, demand for space in developed markets of Australia and Japan remains largely concentrated in core markets and key fringe/suburban locations which are benefiting from spillover effects as vacancy rates tighten in CBD markets. In contrast, in emerging office markets demand has been generally focused in decentralized locations. The contrasting focus reflects the impact of shifting supply and demand dynamics in recent years.

Chart 3: APAC CBD Office Fundamentals

(in %)



Source: CBRE, UBS Asset Management, Global Real Estate Research & Strategy, as at June 2016

On the supply front, delivery of new supply has been – and will continue to be – focused in core CBD locations in developed markets since the financial crisis. In emerging markets, new supply has been concentrated in decentralized locations which have emerged as alternative office sub-markets for occupiers as a result of changes to re-zoning policy and improved public transport connections. On the demand side, diverging trends in rents since the financial crisis has allowed occupiers to refocus their leasing strategies on CBD markets in Australia and Japan, which saw large rental declines in the aftermath of 2007, but forced corporates in China's key cities into alternative office locations given elevated occupancy costs in CBD markets.

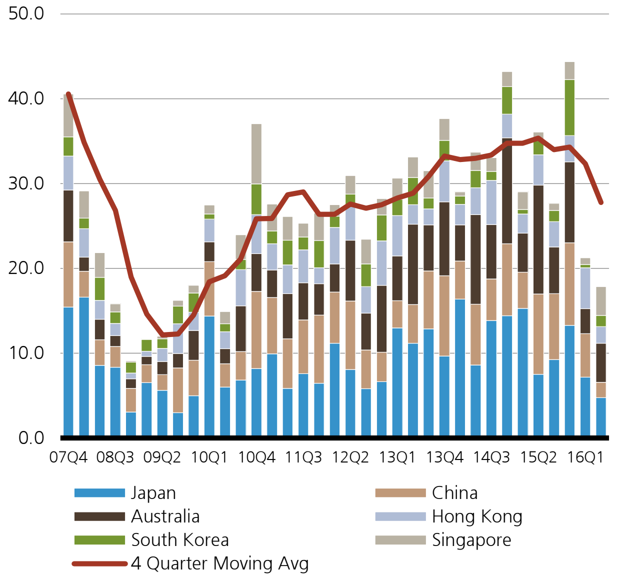
In Singapore, rising office supply levels and weak demand from the financial sector are set to push rents lower over the next 12-18 months. Despite tight vacancy levels, rents in the Hong Kong market are likely to slow in the near term on account of slower growth in China, subdued demand from the financial sector and three new office developments in the CBD. In Japan, rising supply levels is set to pressurize both occupancy levels and prime rents from end 2017 onwards.

APAC Capital markets

Data from RCA for 2Q16 suggests that investment activity excluding land sales has fallen 48% YOY across the APAC region (in USD terms). The sharpest declines have been seen in the industrial and retail segments, which have seen transactions fall 55% and 67%, respectively. Even after taking into account the impact of the stronger dollar (outside of the 12% yen strengthening which would flatter USD-denominated investment volumes in Japan), the pullback in transactional activity has been broad based across the three markets that represent the majority of APAC investment activity (Australia, China and Japan).

Chart 4: APAC Investment Volumes

(in USD billion)



Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

In local currency terms over the year, volumes in 2Q16 have fallen by 50% in Japan, 63% in Australia and 80% in China, although smaller markets such as Singapore have been more resilient, supported by large one-off transactions. On the demand side, the weaker transactional environment reflects a combination of increased investor caution and growing regional political risks, but also reduced supply of investment assets with existing holders of core real estate assets sitting on the sidelines as values continue to move higher.

With 10-year government bond yields moving sharply lower in 2Q16 as a result of Brexit – for existing debt, 10-year government bond yields in Japan fell 20 bps to -0.2%, 50 bps in Australia to 2.0% and 30 bps in the US to 1.5% – the impact of low returns on fixed income (for holding periods equivalent to a typical property investment) and lack of alternative options for reinvested capital is likely to ensure that overall investment activity remains subdued in the near term.

In terms of performance, core real estate values in the developed markets of Japan and Australia, Tier-one cities in China and certain market/sector combinations such as Hong Kong offices, continued to grind higher in 2Q16. Preliminary data suggests the uplift has been driven by rent growth and some further minor yield compression in select markets. Core performance in developed markets of Australia, Japan and Hong Kong offices is likely to remain relatively healthy in 2H16 despite the macro outlook remaining weak (Japan) or sluggish relative to historical averages (Australia and Hong Kong). In the near-to- medium term, the key constraint for new capital will be finding suitable product to purchase in APAC. Although there are downside risks to the outlooks for China and Japan's economies, we expect that the "lower for ever longer" environment supports core performance in the near term.

China

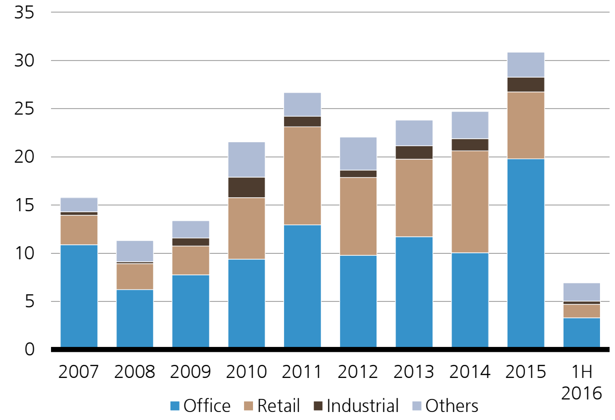
In line with Beijing's growth guidance range of 6.5-7.0% for 2016, Chinese GDP came in at 6.7% in both 1Q16 and 2Q16, supported by marginally improved export numbers, steady infrastructure investment and robust consumption growth. In 2H16, total retail sales of consumer goods reached RMB 15.6 trillion, a nominal YOY rise of 10.3%. In particular, sales of household appliances, autos and communication appliances saw respectable growth, providing tangible evidence that stable income growth is still supporting consumer sentiment. China's per capita disposable income was RMB 11,886 yuan as at 1H16, and showing real growth of 6.5% YOY, which runs parallel to GDP growth.

On July 26, 2016, China's Politburo concluded its mid-year review of economic development and set its policy stance for 2H16. At least on the surface, what remains unchanged is the central government's commitment to boost domestic demand with proactive fiscal and stable monetary policies to achieve near-term growth targets while moving forward with structural reforms that are aimed at supporting sustainable long-term growth potential. We believe that China's growth continues to face headwinds from the loss of momentum in real estate investment and industrial production, and the burden of unsustainable corporate debt remains a downside risk. In late May 2016, China's Ministry of Finance stated via its website that the central government could potentially increase its indebtedness to support the deleveraging of the corporate sector and state-owned enterprise reform initiatives, especially as government debt level remain low. That is a clear sign of the severity of the issue; however, we are of the view that Beijing continues to have a range of policy tools and headroom to navigate the increasingly complex reform agenda.

Growth in 2016 is unlikely to be spectacular on a historical basis; however, China is likely to remain one of the global growth leaders, particularly relative to the sluggish growth in developed markets. To be sure, we are cognizant that China's new normal will be reflected in slower growth, albeit on a greater base, but driven primarily by consumption and the services sector.
Based on RCA data, total transacted value (excluding land sales) in real estate amounted to USD 6.9 billion in 1H16, down by 50% from 1H15 levels of USD 13.4 billion. Foreign capital has turned more cautious in 2016 on account of currency and macro uncertainties, and a general lack of confidence in the policy environment, resulting in a pursuit of higher risk premiums. Approximately half of the total of property investments in China was recorded in the two most liquid cities of Shanghai (34.9% of total) and Beijing (15.1% of total), which is a clear sign of a flight to quality amid the general weak sentiment surrounding the real estate markets and wider economy.

Chart 5: China Investment Volumes

China real estate investment volume (excl land, USD billion)



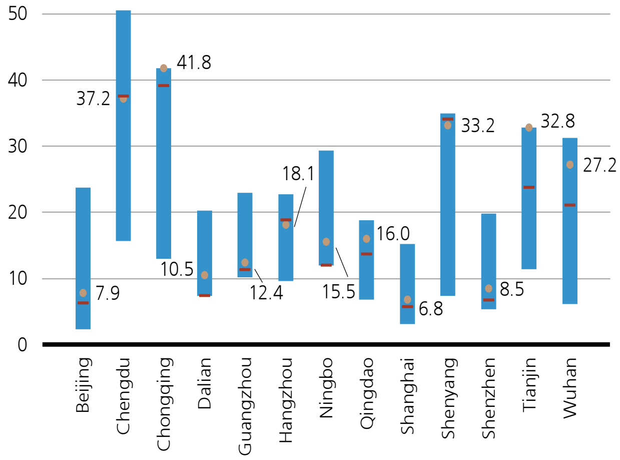
Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

In 1H16, 47.5% of total investments flowed into the office sector, which further exacerbates the situation of capital chasing limited stock, especially for institutional grade assets in China. Investment interest focused on office properties is likely continue into 2017, as operator experience starts to feature more heavily in extracting returns from retail and logistics assets. To that end, prime office yield in Shanghai and Beijing compressed by 25 bps YOY in 2Q16, at 4.50% and 4.25%, respectively. In other major office markets such as Shenzhen, Guangzhou, Tianjin and Chengdu, yields have grinded sideways as transactions were limited in 2Q16.

There continues to be a clear divergence in performance among Chinese office markets, although we have started to see some downward pressure on occupancy across the majority of office markets we cover. Beijing and Shanghai both continue to attract significant leasing interest from financial and technology sectors, particularly domestic companies. Despite the growth of emerging office sub-markets, landlord expectations have remained high and core office rents in Beijing and Shanghai; e.g. Financial Street in Beijing, and Little Lujiazui in Shanghai have held steady in 2Q16, with average vacancy rates below 8%. Average office rent in Shanghai grew by 9.7% YOY in 2Q16, while the office rent in Beijing remained unchanged.

Shenzhen's office sector had earlier been a strong beneficiary of Chinese policies, but we are now observing an about-turn by technology companies, which are relocating to the city's high tech park and peripheral areas for space and cost optimization reasons. This is reflected in the vacancy rate of the office sector in Shenzhen moving outwards from 6.7% in 2Q15 to 8.5% in 2Q16. At the other end of the spectrum, lower-tier cities, in general, reported vacancy rates in excess of 12%. These include cities such as Chengdu (37.2%), Chongqing (41.8%), Tianjin (32.8%), Wuhan (27.2%) and Hangzhou (18.1%).

Chart 6: China's Office Vacancy Rates
(in %)



Source: CBRE, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

New supply coming on-stream is a certainty as multiple CBDs continue to be planned ahead of demand in lower-tier cities. The dire situation of oversupply and poor demand will further exacerbate the softness in occupancy and rents of these cities in 2016, and going into 2017.

The near-term fundamentals of the retail sector point to an interim period of adjustment as the outlook for rents and performance remains uncertain. While consumption growth has been resilient, there have been very obvious leakages in retail spending via e-commerce that have bypassed traditional physical retail channels. The growth of online retailing is the biggest threat to the existence and survival of retailers in China at the moment, with major international retailers increasingly looking to just Beijing and Shanghai as gateways for expansion. We still believe in the long-term appeal of the retail story for China real estate, as the upgrading of consumer markets is almost a certainty, while middle class aspirations and higher wages provide a long-term impetus for spending growth. However, this also means the operational ability of retail landlords to transit smoothly into omni-channel modes of retailing and a greater focus on experiential shopping will define the winners and losers.

It is clear that there will be more losers than winners. In Beijing and Shanghai, there continues to be a dearth of retail space in prime and well-established locations as reflected in the strong YOY showing in rental growth of 10.8% and 5.3% in 2Q16, respectively. We do, however, expect retail performance in Beijing and Shanghai to remain broadly flat for the remaining of 2016. At the right entry price point, the repositioning of ageing but well-located retail assets in Shanghai and Beijing is looking to be a reasonable strategy for strong operators to gain access to the retail sector.

The logistics sector is an unobvious second-order manifestation of China's progress in rebalancing its economy. As an alternative proxy for the consumption theme in China, the demand for warehousing and cold storage facilities continues to intensify amid a structural shortage. In the area of industrial upgrading, China's state-level initiative to foster innovation and drive the "Made in China 2025" goal will result in greater demand for high-quality industrial workshops catering to tenants engaged in advanced engineering and value-added manufacturing in new growth sectors (such as renewables, robotics, transport engineering and pharmaceuticals). Despite policy encouragement by the government to develop the logistics backbone of China, there is increasingly limited availability of industrial land. Primary logistics hubs have in general reported decent YOY rental growth in 2Q16. These include cities such as Shanghai (5.0%), Nanjing (5.0%), Hangzhou (5.0%), Ningbo (5.0%) and Shenzhen (2.8%). In other cities where there have been speculative investments and a run up in supply, asset quality and location selection – e.g. near ports and transport nodes – will be key to driving investment performance.

In May 2016, China's Ministry of Finance and the State Administration of Taxation expanded the scope of the Value Added Tax (VAT) system to cover the real estate sector. VAT of 11% will replace the existing 5% business tax which was based solely on revenue. We believe that while the intentions are clear and positive for the property sector, the immediate implications could be multi-fold and uncertain. For one, real estate used for production and operational purposes, such as factories and office space, will now be eligible for tax deduction. This may incentivize companies to purchase their own real estate to reduce holding costs, thus providing much needed support towards real estate investment. However, landlords are now also subject to the VAT, and may pass on this burden to tenants in the form of increased rents. We may end up seeing a greater polarization in rents as landlords of high-quality properties in prime locations will be in stronger position to transfer this cost to tenants, whereas owners of lower quality assets may be forced to take a cut in their margins to offset the VAT tax. Regardless, this move to a VAT structure is a clear sign of progress in China's reform goals, as it shifts into a more equitable tax system that can help foster growth in the services sector.

Hong Kong

It is not off the mark to describe Hong Kong's current predicament as being between a rock and a hard place. Its long-term outlook is shaped by developments in China, yet it is fully exposed to the shifts in global financial and political events. From our last update, economic conditions have been broadly stable. Softness in the Chinese economy has been hampering export growth and retail sales, while the currency peg to USD was pushing up borrowing costs (in expectation of potential Fed rate hikes) and undermining domestic competitiveness. Overall growth momentum for 2016 remains weak amid external headwinds and subdued domestic demand.

Economic linkages with mainland China remain the most important catalyst for ongoing prosperity in Hong Kong, but we also note that heightened political risks from rising social tensions may increasingly become a key point of concern for investors. That said, Hong Kong's economic fundamentals remain sound on account of a well-regulated financial and banking sector, strong fiscal position and a tight labor market that supports wage gains.

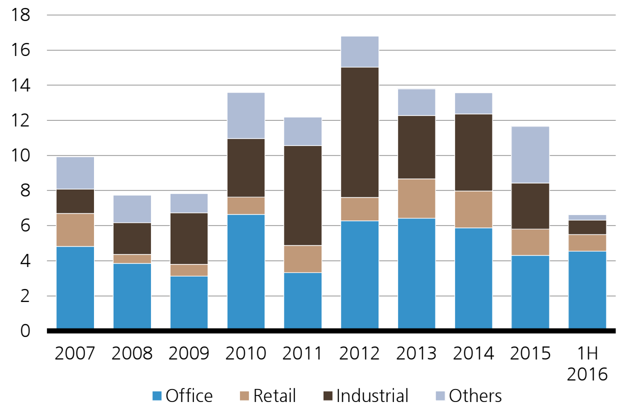
The relevance of Hong Kong as an international office market has been increasingly thrust into the limelight, as the occupier profile of the office sector shifts from a clear dominance by multinational firms towards a market driven by growing demand from Chinese mainland occupiers. This growth in demand from mainland China firms, particularly from the finance sector – which accounts for over a third of all reported CBD demand in the past two years – has played a key role in supporting office rents in Central which have grown 12.9% YOY in 2Q16. Despite healthy demand, Grade A office vacancy rates rose slightly to 4.2% in 2Q16, up from 3.5% in 1Q16 as a result of greater occupier decentralization.

Our view is that by end-2017, growth in the Hong Kong office market is likely to slow due to financial market volatility, affordability constraints and the delivery of new CBD offices to the market. However there are ample opportunities for the repositioning and asset enhancement of older office assets in core areas, which could well prove to be a tactical strategy to capture rental reversion, particularly for selective tenants looking at smaller floor plates in well located areas.

In the retail sector, total sales remain under pressure, driven by the strengthening currency and travel restrictions on visitors from China. Visitors from mainland China account for almost 80% of total tourist arrivals into Hong Kong, and drive the bulk of tourism receipts. Near-term prospects for the Hong Kong retail market remain muted as retailers cut back on their expansionary plans, despite weakening rents across the board. CBRE has also observed that landlords are now willing to enter into shorter lease terms in order to maintain occupancy levels. To that end, prime high street rents have declined 33.3% on a YOY basis in 2Q16, while average retail are down 16.9% over the same period. That said, domestic consumption of necessity goods will hold up, supported by the tight labor market even as overall consumer confidence weakens on the back of lower wealth effects from a slowing property market. We believe mainstream-focused suburban malls will outperform in the retail segment. In the investment market, total transacted volumes declined almost 43.5% YOY in 1H16, with transactions limited to non-core retail segments supported by non-discretionary spending.

Chart 7: Hong Kong's Investment Volumes

Hong Kong real estate investment volume (excl land, USD billion)



Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

Leasing demand for industrial space is likely to remain subdued over the next 12 months as the trade and retail sectors continue to feel the squeeze from slowing global trade and retail lethargy. In 2Q16, average warehouse rents increase marginally by 1.0% YOY. On the supply side however, under the industrial revitalization scheme that ended on 1Q16, landlords have rushed to submit planning applications for change of use, which is likely to constrain the amount of near-term stock available for occupation as these applications are reviewed and approved gradually. As such, rents and vacancies are set to move sideways in 2H16, despite subdued occupier demand and increased focus on cost savings.

Singapore

Based on advanced estimates from the Ministry of Trade and Industry, the Singapore economy expanded by 2.2% in 2Q16, marginally higher than the 2.1% recorded in 1Q16. Sluggish domestic and external demand drivers continue to paint a fairly weak picture for 2016. While the financial and trade-related service sectors should perform relatively well, the longer-term challenge of a shrinking labor force and restrictions on foreign labor continues to hurt business costs and corporate investment, especially for small enterprises. However, the outlook for household spending appear to be holding up better than expected, as short and long-term interest rates rise less rapidly over the coming quarters against a background of gradually tightening US policy. The tight labor market should also support consumption in the near term.

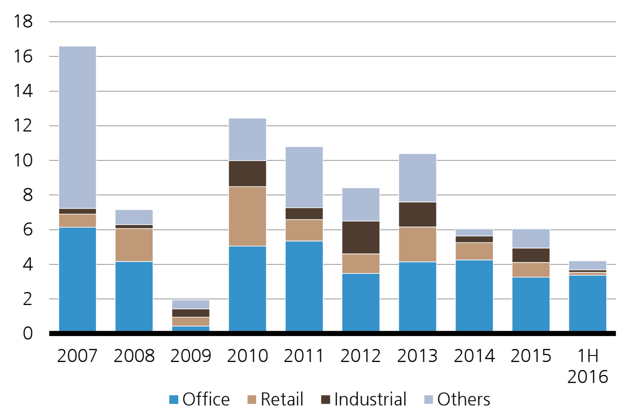
Singapore's medium-to-longer term prospects remain healthy. The government expects that restrictions on foreign workers and tax incentives are likely to spur sustainable productivity growth by encouraging firms to invest in labor-saving technologies. And overall, Singapore's fiscal strength and political stability will continue to ensure it remains one of the leading economies in Asia Pacific amid regional and global headwinds.

Office tenant retention is now expected to be given higher priority by landlords, given future competition from new development options, which will exert a downward pressure on rents. Grade A CBD core rents declined for the fifth consecutive quarter in 2Q16, falling by 4.0% Quarter-on-quarter (QOQ). Corresponding vacancy rates stood at 5.2%, up from 4.4% in 2Q15. We foresee the flight to quality trend in the office space picking up pace as occupiers take advantage of lower rents.

Our practical view is that the fundamental issue facing the office sector now is not the sharp supply influx, but the bunching of completions in 2016. The completion of Marina One is likely to raise the overall vacancy rate in the Grade A office segment in 2016, and Guoco Tower and Duo will also substitute leasing demand away from the core CBD area. However, we are likely to see a supply shortage post-2018, which should provide some support for fundamentals. In the meanwhile, selective well located office assets with favorable lease expiry schedules should continue to outperform the market in the next 12-18 months in light of the impending downward pressure on prime rents and occupancy. In the investment market, 14 transactions above USD 10 million were recorded in 1H16, and total transacted volumes increased by almost 98% YOY to reach USD 3.4 billion, mainly driven by the sale of Asia Square Tower 1 to the Qatar Investment Authority in June 2016.

Chart 8: Singapore's Investment Volumes

Singapore real estate investment volume (excl land, USD billion)



Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

In the retail sector, while a clear tenant market has emerged, expansionary plans of retailers are still being largely put on hold. The key drag on retailers is the limited availability of labor supply, which is eroding profit margins, not less in an environment of weakening retail sentiment. On a more positive note, there is very little known new supply coming through the pipeline in prime Orchard Road, although we do have doubts as to the sustained dominance of Singapore as a global shopping destination, especially as regional cities such as Tokyo, Bangkok and Seoul start to gain prominence among international tourists and retailers. Prime retail rents fell by 4.4% YOY in 2Q16, the sixth consecutive quarterly decline. In contrast, suburban retail rents were more resilient throughout 1H16, falling away only slightly in 2Q16, in which average rents recorded a 2.8% decrease YOY. Looking ahead, retail rents (both prime and suburban) are likely to register flat to marginal declines over the next 12 to 18 months. However, the sophistication of suburban shopping centers in Singapore will continue to apply pressure on prime retail, and we believe investors looking at core retail assets might be better off with well-located suburban retail where catchment income is more resilient and there is greater scope for asset enhance initiatives to pay dividends in a shorter time period.

With the industrial property sector generally correlated to sentiment and the underlying performance of the manufacturing and export sectors, the near-term outlook for the sector is expected to be soft. However, the government-led shift towards greater automation and knowledge intensive industries has begun to gain some traction although at a measured pace. Industrial sub-sectors such as advanced manufacturing, transport engineering and business parks are likely to be less impacted by the lethargic manufacturing landscape and should continue to underpin resilient demand for high quality industrial space. The value proposition of business parks as a cost-efficient quality office alternative (due to the attractive rental differential) will also continue to be a major drawing point, particularly those that are better located and of higher specifications.

Japan

The Bank of Japan's (BoJ) monetary easing efforts in recent years have been largely offset by the sharp fiscal adjustment that began 2014 which was followed by further tightening last year. Clearly, recent developments in the global economy also haven't helped the BoJ in achieving its 2.0% core inflationary target. Headline CPI inflation stayed on course for a three-year low of -0.4% in June 2016 while core inflation (excluding fresh food and energy) fell for the third consecutive month in a row to 0.4%.

Heightened risk aversion in the aftermath of the UK's EU Referendum has seen a flight to "safe haven" currencies including the Japanese yen. However, even before the impact of Brexit, the most recent BoJ's Tankan survey in July 2016 was already suggesting domestic business conditions had weakened. Survey results showed that businesses expect a

7.2% fall in profits this fiscal year, compared with a 2.5% fall in the last survey in March. Large manufacturers selling to overseas markets, and thus most exposed to currency movements, expect profits to fall by almost 12% in 2016. More importantly, private investment intentions have also been scaled down with corporates preferring to maintain cash balances at the expense of capital spending and wages.

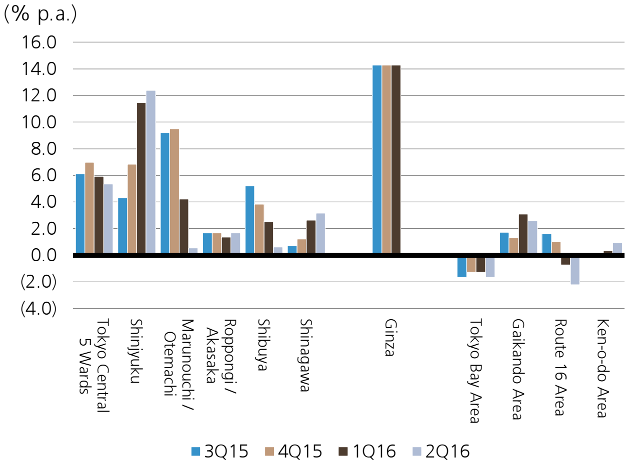
On July 10, Japan's ruling Liberal Democratic Party and the Komeito coalition scored a resounding victory in the Upper House election, which can be viewed as a victory for Prime Minister Shinzo Abe and a strong signal that voters back his efforts to boost growth potential. Having recognized that further fiscal tightening could derail the macro recovery and exit from deflation, the government has recently announced a shift towards fiscal easing.

Alongside any further easing from the BoJ in September, the government's additional fiscal package, which involves the postponement of the planned April 2017 consumption tax hike and increased infrastructure spending will help boost near-term growth. Although the strengthening yen remains a concern for exports and corporate earnings growth the overall strength of Japan's large corporate sector remains healthy in an environment of low borrowing costs and generally healthy sentiment. Beyond the near term, structural reforms will be needed to boost Japan's potential growth rate, including incentives for corporations to spend their vast cash holdings.

Despite elevated financial market volatility and the pullback in investment transactions in the first half of 2016, prime property yields across all sectors were broadly stable in Tokyo. In part, the stability of pricing was supported by the decline in yields on risk free assets and lower debt servicing costs over the quarter, both of which are the direct result of the BoJ's quantitative easing program and the introduction of NIRP.

Grade A office rents in Tokyo are set to continue rise in the next 12 months given that known supply remains limited and vacancy rates remain tight. Across Tokyo, the Grade A vacancy rate fell below 2% for the first time since 2008, and underpinned the increase in assumed achievable rents by 1.4% QOQ to JPY 35,400 per tsubo in 2Q16. Despite corporates gradually turning cautious on expansion, the increased business activities of recruitment agencies, IT firms and local financial institutions will continue to support office space demand, especially in the relocation to larger floor spaces.

Chart 9: Tokyo's Prime Rental Growth, by sector



Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

We retain the view that stabilized Grade A office buildings in prime fringe locations close to main rail or metro line stations should continue to outperform in the near term given the preference of employees to be close to public transport. Also, asset enhancement initiatives on well-located Grade B office assets is a strategy that best suits investors with strong experience in upgrading the corporate image of ageing buildings, thereby riding on the possible rental reversions.

In the logistics sector, the vacancy rate for Large Multi-Tenant logistics properties (LMT) in the Greater Tokyo area rose to 8.3% in the latest quarter on account of large levels of new supply. Although net absorption remains robust, it was not enough to fill all the newly completed space. In contrast, vacancy for existing facilities (defined as those older than 12 months) remains tight, at just 1.7%, reflecting the fact that the rise in vacancy was driven by the new supply being delivered to the market.

Despite Japanese corporates becoming more cautious in recent months, buoyant demand for logistics space has been driven by structural changes, such as the growth of e-commerce and labor shortages. Demand for modern logistics space is unlikely to slow sharply as a result of a near term pullback in business confidence. Nevertheless, this year is scheduled to be another year of record new supply, as was 2015, and some properties will take an extended period to lease. However, overall supply-demand dynamics should remain balanced across Greater Tokyo, although there is likely to be a wider gap between areas. While three of the four areas are likely to remain tight, Ken-O-do (the outer-most area), is likely to see its vacancy rate remaining above 10%, and its rents are likely to remain under pressure over the next two years.

Australia

Australia's economic growth model continues to shift away from mining and resource-rich states, albeit at a gradual pace, supported by lower interest rates, a weaker currency (relative to the past five years), and asset price inflation, particularly housing. The reversal of commodity prices is hitting nominal GDP growth and related variables that are linked to turnover, such as corporate profits, wages, and government revenue. Importantly, however, the real economy is being supported by a pickup in services sector activity on account of structural shifts taking place in China and the broader region.

Despite the subdued wage environment, consumer spending has been supported by healthier jobs growth over the past 18 months; durable goods purchases related to housing turnover and refurbishments; and declining mortgage rates. Lower borrowing costs have boosted the spending power of households with variable interest rates which would otherwise have been used to service existing debts. To some extent, the wealth effect has also played a role for existing homeowners and investors as rising house prices have improved the balance sheets of households, at least at an aggregate (national) level.

Rising net wealth and lower debt servicing costs have allowed existing homeowners to increase their spending beyond the level that would be dictated by wage growth, either by cutting back on their savings or borrowing against their (higher) net worth. In fact, the recent fall in the household savings rate follows a sharp rise in the level of precautionary savings triggered as a result of increased uncertainty about future wages and job security in aftermath of the financial crisis.

Clearly, there are limits to the extent that rising house prices can support consumer spending, particularly as residential markets slow (at a national level) and existing owners set outside more of their current income to meet the higher obligations of future generations, whether its related to housing or student education debt or increased taxation to fund an aging population. Moreover, the corollary of higher house prices is that new homebuyers are being forced to take on ever larger mortgages to enter the market. Beyond housing market slowdown, a gradually tightening labour market should eventually support higher wage growth which represents a more sustainable driver of consumer spending over the medium term.

Overall, the consumer sector, housing construction and exports are expected to offset ongoing headwinds from the normalization of commodity prices, capital spending cuts and the moderately restrictive fiscal stance. The key downside risk that could derail this relatively healthy near-to-medium term outlook include a sharper than expected global slowdown which would have knock on impacts for the domestic housing and banking sectors via a slump in employment and higher defaults.

In the office sector, the recovery of Australia's leasing market is gradually taking place with the Sydney and Melbourne the main beneficiaries of shifting macro and sectoral drivers. Importantly, these shifts are supportive of overall demand and supply dynamics in these markets. Fundamentals in Sydney and Melbourne are being supported by relatively healthy leasing activity and limited net new supply via the withdrawal of average quality stock for conversion into residential apartments and other uses.

Net absorption exceeded its long-term average for Sydney and Melbourne in 2015. In part, this recovery in leasing activity has been driven by pent-up demand as occupiers delayed their occupational decisions between 2011-13 in response to a hit to business confidence levels, which was in turn triggered by the pullback in commodity prices and elevated macro uncertainty. As growth prospects stabilize in the services sector, expansionary demand is beginning to support leasing activity in certain sectors. The key sectors that are underpinning the demand for office space include domestic finance and insurance, professional services, education and the Information, Communications & Technology (ICT) sector.

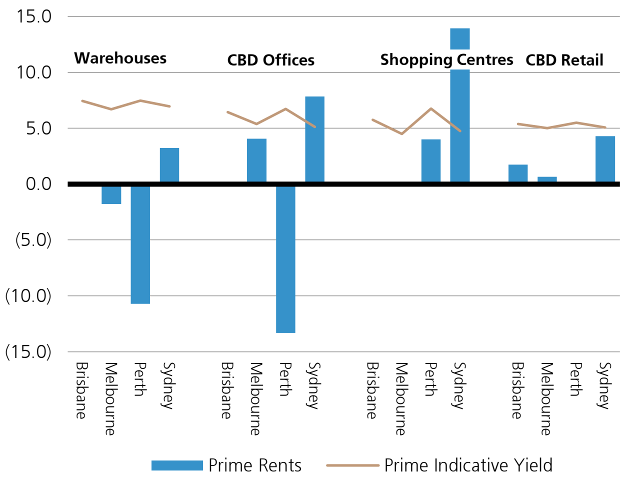
On the back of improving demand and limited new supply – adjusted for space withdrawn for change of use including residential stock and mixed use schemes – CBD vacancy rates in 2Q16 are estimated to have fallen to 6.1% in Sydney and 6.6% in Melbourne, from 6.3% and 7.7% in 4Q15, respectively. This compares to 15-year averages of 7.5% for Sydney and 7.0% for Melbourne. Vacancy rates are expected to continue to remain low and stable over the medium term, which should help to support above inflation rental growth, particularly if incentives tighten from current levels. Over the longer term, rental growth is likely to be limited by affordability constraints in Sydney and low-cost alternative submarkets in Melbourne.

Net absorption levels in the resource-rich states of Queensland and Western Australia continue to lag but even here demand is stabilizing in Brisbane and becoming less negative in Perth. In Brisbane, stabilizing demand from the state government and rising demand from the education and tourism sectors are offsetting the contraction from the mining sector and related services. Although net absorption is becoming less negative we believe it will be a couple of years before Perth's fundamentals stabilize. Elevated levels of near-term supply will continue to pressurize vacancy levels this year. Vacancies are expected to remain high in Perth and improve in Brisbane (albeit from elevated levels) over the medium term. Rents are expected to rise from floor in Brisbane and Perth although substantial over renting remains.

In the retail sector, in an environment of subdued wage inflation and slower population growth nominal retail sales are growing at a slower pace than long-term averages. Global macro uncertainty combined with elevated leverage are also weighing on consumer sentiment, with household saving rates remaining elevated relative to pre-crisis levels. Overall, annual sales growth has slowed to 3.3% in June 2016 compared to 4.2% over the past 10 years. Near-term growth are likely to remain subdued in the near term as global macro uncertainty weighs on confidence. However, on the assumption that healthy jobs growth supports a pickup in wage inflation, growth is likely to return to 4% p.a. range over the medium term. In the leasing markets, prime CBD markets continue to be supported by the growing presence of international retailers where penetration levels remain low relative to other global cities and healthy demand from Chinese tourists. In addition, supply is demand driven and often asset specific particularly in Sydney and Melbourne where vacancy for super prime space is virtually non-existent.

Chart 10: Australia's prime rent growth and yields, by sector

(prime rental growth, % p.a. and indicative yields, %)



Source: CBRE, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

In the domestically-focused retail segments, overall demand remains heathier in regionally dominant shopping centers and large format retail, the latter being supported by robust housing markets, particularly in Sydney and Melbourne. These trends are similar to those observed in other developed markets as households focus their spending in centers that can offer alternative consumer experiences and locations with strong food and beverage offerings. Supply is increasing but the development pipeline is consistent with historical averages. Nonetheless, with nominal sales growth subdued relative to historical averages, rent growth is set to be limited to inflationary pressures.

The ongoing contraction of Australia's manufacturing sector continues to constrain leasing demand in the industrial sector. The manufacturing sector is expected to contract further this year before stabilizing at around 1% p.a. growth from 2017 onwards. The flipside of declining domestic production has been the growth of imported goods, which has underpinned increased demand for warehousing space and logistics space. In this segment, the outlook remains positive. Large modern logistics facilities in key distribution hubs – in particular those close to major infrastructure developments – and smaller units in infill sub-markets that are positioned to serve urban locations continue to see healthy demand from retailers and 3PL providers on account of new growth in the e-commerce space and increasing demand for efficiency in both transportation and warehousing of goods. With online spending capturing an increasing share of total sales, demand for logistics space is expected to remain strong, especially single tenanted built-to-suit facilities. However, new space is coming on online steadily in certain sub-markets which will lead to more parity between supply and demand and rising vacancy for smaller spaces.

Similar to other regions and markets, limited availability of assets for sale in 2Q16 has seen investment activity fall to USD 4.6 billion in 2Q16 down from USD 12.8 billion in 2Q15. A stalemate exists with current real estate owners reluctant to sell their existing exposure on the expectation of higher pricing this year. Existing investors also face the prospect of lower returns on re-invested capital. Despite elevated financial market volatility in 2Q16, domestic and foreign investor demand for commercial real estate exposure remains strong. The lack of core product available for sale means that new investors are looking to secondary cities and markets, value added opportunities and niche strategies to satisfy their investment requirements.

Despite the pullback in liquidity, the imbalance between investor demand and supply continues to support pricing in both CBD and suburban office markets of Sydney and Melbourne and the prime CBD segments in Brisbane, Adelaide and Canberra. In Perth, yields have fallen in recent quarters as a result of falling rents and occupancy levels (numerator in the calculation of a property yield) rather than rising capital values (denominator).

Secondary yields in the CBD markets of Sydney and Melbourne continued to track lower in 1H16 supported by healthy fundamentals and withdrawal of stock, narrowing the spread between prime and secondary assets. Pricing of Grade B assets in CBD and inner city suburban office markets continues to be supported by withdrawal of stock for conversion into residential apartments and other uses such as hotels and compulsory acquisition for public infrastructure purposes, particularly in Sydney.

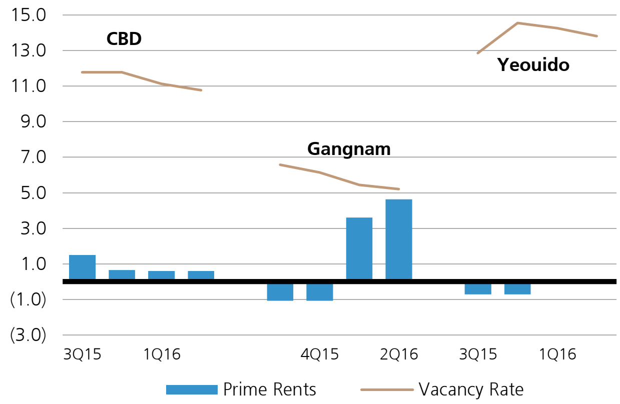
In terms of absolute pricing, prime and secondary values per square meter are now higher than pre-crisis levels – at least in nominal terms – and indicative premium yields are back to pre-crisis levels in Sydney and Melbourne. However, in contrast to pre-crisis environment, real estate looks reasonably priced on a relative basis compared to both pricing in the pre-crisis period and return expectations for other asset classes. In the absence of a sharp pickup in financial market volatility, with the RBA cutting rates further 50 bps and 10-year government bonds falling 100 bps in the year to date, property values are likely to continue firming in 2H16, albeit at a slower rate.

South Korea
Following healthy growth in 2H15, macro conditions have moderated somewhat in 1H16. In 2H15, quarterly GDP averaged 0.9% driven by a pick-up in household spending which was able to offset export weakness. Quarterly growth has slowed to 0.6% in 1H16 with most components of GDP maintaining a sluggish trend. Despite broader uncertainty about the global economy and sluggish domestic demand, capital spending has proved to be relatively resilient due to strong growth of private residential construction as a result of recent rate cuts, which offset a decline in other types of investment.

Moving into 2H16, the economy continues to face headwinds, particularly for exports and capital spending outside of private housing. Weak external demand continues to have a dampening impact on growth. A sharp recovery in external demand is unlikely given the outlook for global trade growth remains subdued. Outside of the electronics segment, the outlook for Korea's heavy industries, in particular shipbuilding and steel, remain weak. Given the sluggish state of the world economy, both monetary and fiscal authorities are likely to maintain their easing bias although the scope of further rate cuts is likely to be limited unless there is evidence of a serious threat to the domestic recovery. Overall, the economy is likely to expand by around 2.5-3% in the next two years, compared to pre-crisis growth of close to around 5% p.a. in the decade prior to the financial crisis.

In the office sector, prime and average rents remain broadly stagnant on account of elevated vacancy and subdued demand for expansionary space from corporates. Prime face rents were unchanged in 2Q16 at KRW 38,735 per sqm in the CBD market; KRW 32,202 per sqm in the Gangnam Business District (GBD); and KRW 31,535 per sqm in the Yeouido Business District (YBD). Generally, tenant incentives including rent-free periods and relocation fees remained at a similar level as 1Q16.

Chart 11: South Korea's office fundamentals,
(prime rental growth, % p.a. and vacancy rate, %)



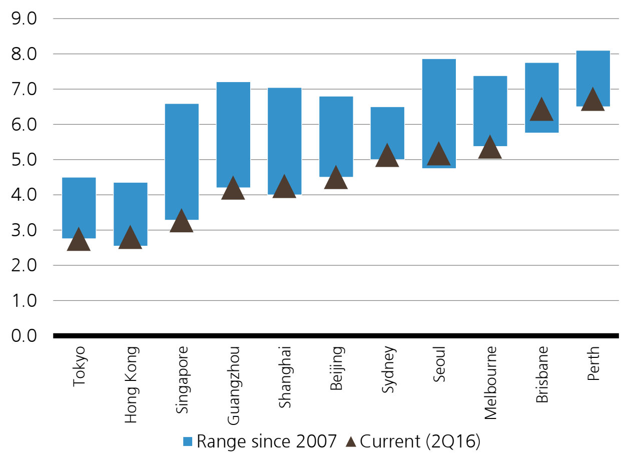
Source: CBRE, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

The vacancy rate across Seoul's Grade A office buildings increased marginally to 9.7% in 2Q16. Mixed results were identified with some tenants moving out of the main business districts, while leasing demand from local corporations was also evident over the quarter. In the CBD, the vacancy rate has generally fallen from peaks reached in mid-2012 of ca. 15% down to 10.6%. The GBD remains the tightest sub-market, although the vacancy rate has increased in 2Q16 to 5.6% from 4.6% in 1Q16. The increase is largely due to the departure of Samsung electronics that were originally located in both Samsung Life's Seocho Tower and in Hanhwa Life's Seocho HQ. In the YBD, the vacancy rate remains elevated at around close to 14% having risen from close to 0% in 2008.

Looking ahead, new supply is likely to ensure that overall rent growth remains subdued and tenant incentives are elevated relative to pre-crisis levels, albeit there will be some variation across individual assets and sub-markets as tenants relocate to competing sub-markets or out of the main business districts. Strong competition among landlords of existing old Grade A and B office buildings for tenants is likely to ensure effective rents remain under pressure in the near term.

Strategic viewpoint
Although yields across the APAC region are at or close to historical lows, demand for real estate exposure in a multi-asset context is set to remain healthy in the near-to-medium term. Capital inflows into the asset class will continue to be supported by broad structural shifts across the region related to – on the one hand – demographics and demand for income producing assets, and – on the other – (ex-ante) excess supply of private (household and/or corporate) sector savings. Part of this excess savings will continue to find its way into real estate, both in APAC and in other regions (or is gradually finding its way into private real estate as in the case of Japan).

Chart 12: APAC CBD Office Yields South Korea's office fundamentals
(in % p.a.)



Source: CBRE, UBS Asset Management, Global Real Estate Research & Strategy, as at August 2016

In the absence of a sharp pick-up in regional macro growth – driven either by a pick-up in credit growth or external demand, none of which are likely anytime soon – return expectations for new capital are likely to be lower over the next five years compared to recent performance and historical averages. However, with long-term interest rate expectations falling sharply since Brexit, yields on government bonds have been pushed further into negative territory in Japan and safe haven European markets. As such, on a comparative basis, real estate pricing and return expectations continue to look relatively attractive for new capital. On the flip side, the elevated yield spread offers investors some downside protection should the US economy see tighter than expected interest rates in 2H16 and into 2017.

How should investors into the APAC region be positioned over the near-to-medium term?

- Focus on quantifiable income creation strategies, including selective value-added opportunities, and be cautious of any investments that depend on yield compression and above inflation capital growth to drive performance;

- Favor markets and sectors where the spread to the risk free rate is above its long-term average and borrowing costs are accretive to leverage, such as Australia, or where occupational markets remain tight, such as China's Tier 1 cities and Hong Kong, and where there are clear, value-added opportunities for new capital; and

- Favor themes that are linked to China's ongoing structural shift towards service sector jobs and consumption – such as hotel exposure in Japan, emerging retail locations that are seeing strong growth from Chinese tourists, or rising online sales such as good quality modern logistics space.

Real Estate Research & Strategy – APAC

David Roberts
Shaowei Toh

For more information please contact

UBS Asset Management
Global Real Estate Research & Strategy

David Roberts
Tel. +61-2-9324-3205
dave.roberts@ubs.com

www.ubs.com/realestate