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Asia Pacific Real Estate Summary.

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APAC leasing demand in line with historical averages

Rental growth limited to supply constrained CBD and submarkets

Liquidity focused on key APAC markets and cities

Generally positive outlook for 2016 but macro and geopolitical risks persist

Demand

Macro conditions have generally stabilized across APAC relative to January's low point, which was characterized by elevated financial market volatility, falling commodity prices and declining global trade which many regional markets depend on to support activity and jobs. Importantly, high frequency economic data for China has surprised on the upside in recent months. In particular, manufacturing, exports and housing – key sectors that have weighed on activity in recent quarters – are showing signs of stabilizing on account of further monetary easing and renewed government efforts to stimulate activity. This fiscal stimulus includes increased financing of infrastructure spending and widening of the budget deficit for this year via corporate tax cuts and unemployment benefits for workers laid-off during China's shift to services sector led growth.

Unsurprisingly, commodity prices have rallied, albeit from low levels, on better than expected macro data. Higher commodity prices are providing some relief for regional resource exporters, helping to offset recent weakness in household incomes and profits. Although downside risks remain – particularly around the sustainability of credit in China, concerns about the effectiveness of further monetary easing, and downgrades to APAC's longer term growth potential in the absence of structural reforms – for the moment, at least, better than expected economic activity should support leasing markets and fundamentals in the near term relative to our views 3-6 months ago.

Overall, net absorption across the key APAC office markets this year is expected to be around 2.4 million square meters this year (2.3% of existing stock) which is slightly above historical averages of 2.2 million square meters, but marginally down on 2015 levels. Given the mix of developed and emerging markets that make up the region though, and the varying degrees to which they are exposed to swings in global trade, finance and commodities, it is not surprising that regional cities are at different stages in their leasing cycles.

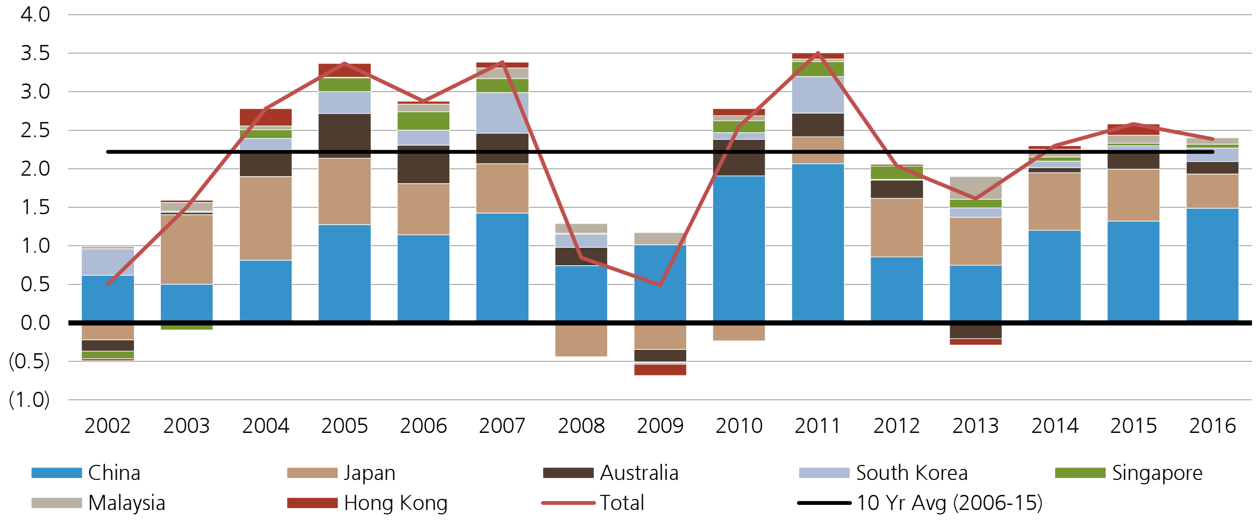
In key developed markets, healthy jobs growth is supporting occupier demand, particularly in the CBD markets of Hong Kong, Japan (Tokyo and Osaka) and Australia (Sydney and Melbourne) where fundamentals have improved over the past 12 months. In other markets, leasing activity remains sluggish relative to historical averages on account of subdued demand from the financial sector, particularly global banking (Singapore) or stabilizing at very low levels as the mining sector shifts to the production phase which requires less headcount than that needed to underwrite and execute new investments (Brisbane and Perth). In China, the gradual shift to services based activity and jobs is supporting leasing markets in the Tier 1 cities where net absorption is expected to be between 10-15% higher than 2015 levels, helping to offset some of the weakness elsewhere.

In the retail sector, leasing demand in the developed markets of Japan and Australia remains focused on prime high streets, dominant shopping centers and locations that are seeing rising demand from Chinese tourists. These trends are similar to those observed in Europe and the US as households focus their spending in centers that can offer 'alternative' consumer experiences and locations with strong Food & Beverage offerings. On the other hand, retail strips in secondary and tertiary locations with poorer quality retailers will struggle in an environment of rising online sales and limited real wage growth, driving an increasing wedge in the sector with the turnover from dominant assets growing faster than overall national sales growth.

In Hong Kong and Singapore, the prime retail segment remains challenging as mainland China's anti-corruption campaign continues to impact luxury spending and there is increased competition from other regional tourist destinations for price-sensitive Chinese tourists. Affordability issues as a direct result of high rents and restrictions on immigration into Singapore which is pushing up wage costs for retailers will constrain prime rent growth in the near term. As Hong Kong's prime segment shifts away from luxury retailers, stabilizing demand and limited supply should support a pickup in prime rents over the medium term. In contrast, the increasing sophistication and growth of suburban shopping centers is likely to constrain the recovery of prime rents in Singapore.

Weak global trade continues to constrain leasing demand in the traditional manufacturing segment of the industrial sector. However, in the warehousing and logistics space, the broad outlook remains positive. Large modern logistics facilities in key distribution hubs and smaller units in infill submarkets that are positioned to serve urban locations continue to see healthy demand from retailers and 3PL providers on account of new growth in the ecommerce space and increasing demand for efficiency in both transportation and warehousing of goods. With consumer spending remaining relatively healthy across the region and 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 online steadily in certain submarkets which will lead to greater parity between supply and demand, and rising vacancy for smaller spaces.

Net CBD office absorption
(million square meters)



Source: PMA, as at April 2016

Supply

Generally, vacancy rates remain tight or tracking lower in the region's key developed cities which is supporting rent growth in CBD office markets of Hong Kong, Sydney and Tokyo. Tighter vacancy rates should support further rental uplifts in 2016. Following relatively healthy uplifts in recent years, prime rental growth is set to continue in Tokyo, albeit at a slower rate, as new supply is delivered to the market. 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. In the near term, growth in the Hong Kong market is likely to slow on the back of financial market volatility, affordability constraints and the delivery of new CBD offices to the market. Growth should bounce back over the medium term given that vacancy rates are likely to remain low and stable. In Korea, the combination of elevated vacancy, new office supply and subdued corporate demand is likely to constrain office rent growth across Seoul's three core submarkets.

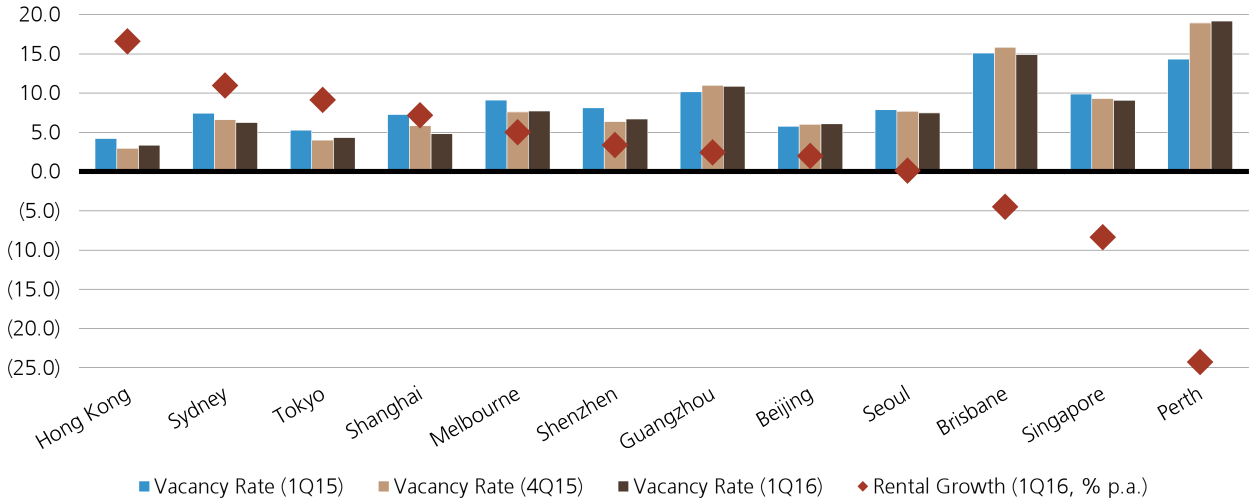
Occupancy levels and rents will remain under pressure in markets that are exposed to elevated levels of supply in the near term alongside weak demand from either the global banking sector (Singapore) or the downturn in mining (Brisbane and Perth). The historical volatility of these markets suggests that rents should pick up once current vacancy and near term supply are absorbed given the development pipeline is thin beyond the next 12-18 months. However, with regulatory pressures cutting into the expansionary plans and profits of global banks and China's shifting demand drivers capping demand for commodities, the growth recovery is set to be subdued compared to previous upswings.

In China, we are observing a greater emphasis by the local governments to recalibrate and act on the commercial inventory overhang. In 1Q16, some Tier 2 cities such as Shenyang, Qingdao and Nanjing, did not see any new office stock being added. Admittedly, this is also in part a reaction by developers to slow down construction in a bid to buy time as they await greater policy clarity and reading of the Chinese macro outlook.

The office markets in China continue to be characterized by two-speed performances between Tier 1 cities and other lower tier cities. Leasing demand remains robust in Shanghai, Shenzhen and Beijing, with average office rents in 1Q16 gaining 7.2%, 3.5% and 2.0% from a year ago, respectively. Domestic financial and technology companies, as well as corporates in the media industry, have driven leasing activity in these Tier 1 markets, and landlords have also become more confident in their rental quotations. Prime office vacancy rates remained tight for Shanghai and Beijing, at around 6.0%.

At the other end of the spectrum, lower-tier cities, in general, reported increases in vacancy rates relative to the last quarter. These include cities such as Chengdu (38.1%), Chongqing (41.0%), Tianjin (30.3%), Wuhan (22.2%) and Hangzhou (17.8%). New supply coming on-stream is a certainty as multiple CBDs continue to be planned ahead of demand. However, we note that one of the government's efforts to support office market decentralization (and thus oversupply) is through the relocation of municipal public organizations to these emerging areas; and some lower tier cities have already embarked on this.

CBD office vacancy rates and prime effective rental growth
(in %)



Source: CBRE, PMA, as at March 2016

Capital Markets

The recovery of APAC capital markets has generally led to the improvement of occupier markets, with monetary easing supporting leveraged income strategies. With the volatility of equities and high yielding credit normalizing – in part, following the actions of central banks which suppressed volatility on either side of the financial crisis and as regulatory changes reduce the ability of banks to support market liquidity – investors have boosted their exposure to alternative asset classes, including commercial real estate, which has supported investment volumes.

However, consistent with the pullback seen on a global basis, APAC transactions fell back in 1Q16 compared to 2015 levels. Using four quarter rolling averages which smoothes the quarterly volatility of transactions, activity (excluding land sales) was down 10% in 1Q16 compared to the 12 months to 1Q15. On account of elevated market volatility and concerns over large capital commitments and transaction costs, investors have become more cautious towards large assets and portfolio deals, particularly in the cross border space given the higher perceived risks of investing beyond domestic markets. Meanwhile, current owners continue to hold off for better pricing conditions before realizing value. In the absence of another bout of global monetary stimulus or sharp pickup in macro conditions, near term investment activity is likely to remain fairly subdued relative to recent years given the pricing disconnect between buyers and sellers.

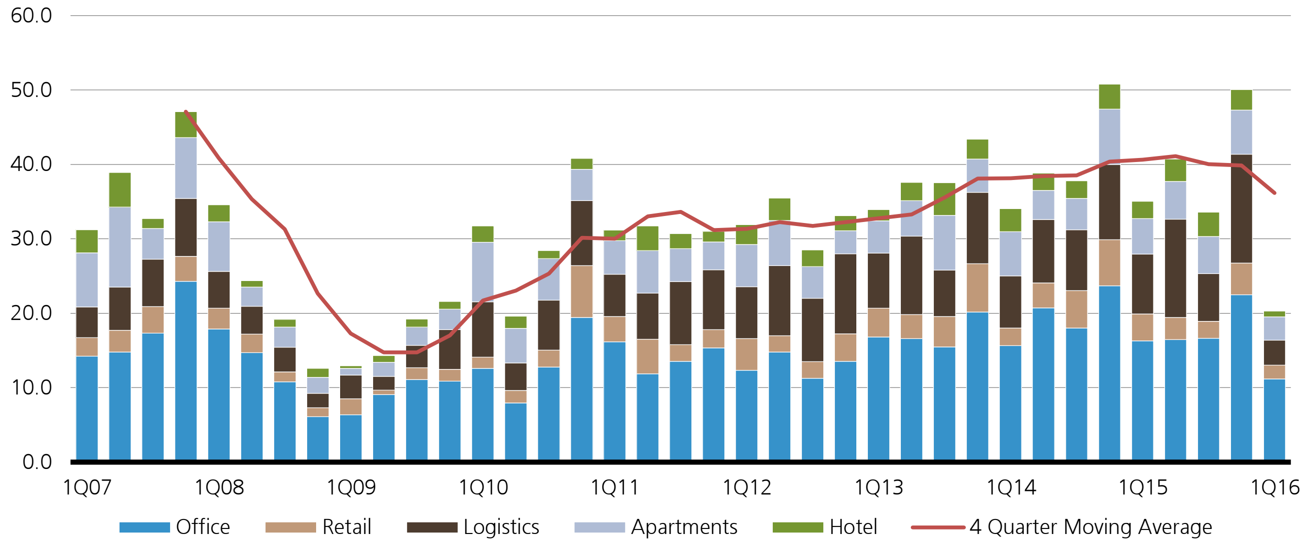
In Japan, investment volumes in 1Q16 fell 35% over the year as investors begin to question the extent and effectiveness of further monetary easing efforts in stimulating core inflation and domestic demand. Overall, investor sentiment in Japan remains relatively healthy, but with prime yields at cyclical lows, further uplifts in values will be limited to income growth. Lower expected returns may constrain overall investment activity in Japan.

In Australia, local institutions have been more competitive in recent quarters, with anecdotal evidence suggesting that required returns have been lowered in line with the return expectations for foreign investors. The pickup in domestic liquidity has helped to offset the pullback in foreign capital. Tighter lending conditions for foreign investors is also playing a role as local banks refocus their lending strategies towards domestic institutions. With policy rates continuing to move lower, domestic investor demand should remain elevated in the near term and the challenge for new capital will be acquiring assets.

Despite the pullback in APAC liquidity, healthy demand and limited supply of core assets is supporting pricing, with prime office yields in key cities moving lower over the past 12 months. This trend continued into 1Q16, with prime yields in regional and secondary cities – particularly in developed markets – moving lower as investors look to boost income returns and diversify beyond gateway markets. Grade B office yields in markets with stronger fundamentals also tracked lower, narrowing the spread between prime and secondary buildings. These assets are often located in submarkets that are either being supported by public infrastructure investment or the withdrawal of stock for conversion into residential apartments or other uses.

In most Asia Pacific cities, prime yields are now close to or below pre-crisis levels, driven by strong investor demand for core exposure. There are exceptions, including Brisbane and Perth where the core pricing recovery has lagged other markets and yields remain elevated relative to pre-crisis levels, reflecting weaker fundamentals. Overall, we believe that we are close to the cyclical peak in terms of core yield pricing, although there may be some further minor compression in some lagging markets. However, with lending conditions tightening at the margin relative to end 2015 levels and foreign capital flows slowing, the extent of any further inward yield compression is likely to be marginal and capital growth will be driven by improving fundamentals.

APAC investment volumes (USD billion, quarterly and 12 month rolling sum)



Source: RCA, 1Q16

Viewpoint

Notwithstanding a further downturn in global trade or return of financial market volatility, macro conditions are holding up relatively better than feared at the start of the year. China's recent round of monetary and credit easing has helped, particularly in those sectors which have been sluggish in recent years. With most economies operating with a fair degree of spare capacity and core inflationary pressures subdued, further monetary easing will provide some additional support for activity and jobs.

However, the room for extra policy easing is more constrained compared to pre-crisis levels, with interest rates lower, corporate and household leverage higher and fiscal deficits and debts elevated relative to 2007 levels. Limited appetite to increase public spending is constraining the ability of governments to roll out additional fiscal stimulus. Beyond further policy easing, what is needed is an overhaul of the growth drivers; structural reforms that raise productivity growth, but which have so far been only tentatively adopted.

For the APAC real estate markets, healthy jobs growth will support occupier demand and, while wage inflation is subdued, end user demand for retail and logistics properties will see further net gains arising from structural changes in consumption mediums and habits. The region continues to attract significant investment into its markets, with core investors attracted to developed markets and China's Tier 1 cities and opportunistic capital attracted to the region's higher growth opportunities. Looking ahead, the investment performance dynamic of real estate is shifting towards income returns and fundamentals as the key driver of returns. In an environment of broadly stable yields, stock selection, asset management and selective capital expenditure will be key to generating outperformance of individual properties and portfolios.

Increasingly, we note that geopolitical risks have risen to the fore in terms of the key concerns that institutional capital may have with regards to assessing real estate opportunities in this region. In Asia, interstate tensions in the South China Sea and disputes between China and Japan over the Senkaku Islands have flared up on several occasions over the last year. Bilateral relationships between North Korea and South Korea have remained in the background for a while, but have also seen some recent downgrades. Domestic political risks were highlighted in Thailand following the military takeover of the government in May 2014, and the outbreak of pro-democracy protests in Hong Kong has also been a result of the rise of nationalism in recent times.

To that end, China is seemingly a common protagonist in the rise of geopolitical tensions across the region, but we believe that it is not in China's best interest to pursue its political goals at the expense of economic connections built up with the region over the last two decades.

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