



# Invesco Real Estate House View

## Asia-Pacific Market Outlook

H1 2012

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## For Further Information

For more information about Invesco's Global Real Estate House Views, please contact our institutional or retail sales team:

### Institutional Sales:

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**Peter McClelland**  
Head of Institutional Sales  
Phone: 02 9006 3011  
Email: peter\_mcclelland@au.invesco.com

**Patricia Newby**  
Senior Business Development Manager - Institutional  
Phone: 03 9611 3614  
Email: patricia\_newby@au.invesco.com

**Maxine Kraut**  
Business Development Manager, Consultant Relationships  
Phone: 03 9611 3681  
Email: maxine\_kraut@au.invesco.com

**Deborah Torgersen**  
Manager, Institutional Business  
Phone: 02 9006 3018  
Email: deborah\_torgersen@au.invesco.com

### Retail Sales:

---



**Sam Sorace**  
National Retail Sales Manager  
(Vic, SA, Tas)  
Phone: 0413 050 909  
Email: sam\_sorace@au.invesco.com



**David Ray**  
Manager Retail Sales  
(NSW/ACT/WA)  
Phone: 0437 404 445  
Email: david\_ray@au.invesco.com



**Matthew Hattersley**  
Manager Retail Sales  
(NSW/Qld)  
Phone: 0414 847 511  
Email: matthew\_hattersley@au.invesco.com

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## Global Real Estate Research Team

Thomas Au  
Director of Asian Research  
+852 3128 6663  
thomas.au@invesco.com

Mike Sobolik, CFA®  
Director of Research, North America  
+1 972 715 5807  
michael\_sobolik@invesco.com

Kim Politzer  
Director of European Research  
+44 207 543 3589  
kim\_politzer@ldn.invesco.com

Guy-Young Lamé  
European Senior Research Analyst  
+33 1 56 62 43 23  
guy-young\_lame@par.invesco.com

Matthias Naumann  
European Research Analyst  
+49 89 20 60 61 31  
matthias\_naumann@mun.invesco.com

Simon Mallinson  
Director of European Research  
+44 207 543 3573  
simon\_mallinson@ldn.invesco.com

Nicholas Buss, Ph.D.  
North American Director of Research  
+1 972 715 7454  
nicholas\_buss@invesco.com

Joyce Galvan  
North American Research Associate  
+1 972 715 7437  
joyce\_galvan@invesco.com

Sara R. Rutledge  
North American Senior Research Analyst  
+1 972 715 7448  
sara\_rutledge@invesco.com

Gordon Yu  
Asian Research Analyst  
+852 3128 6664  
gordon.yu@invesco.com

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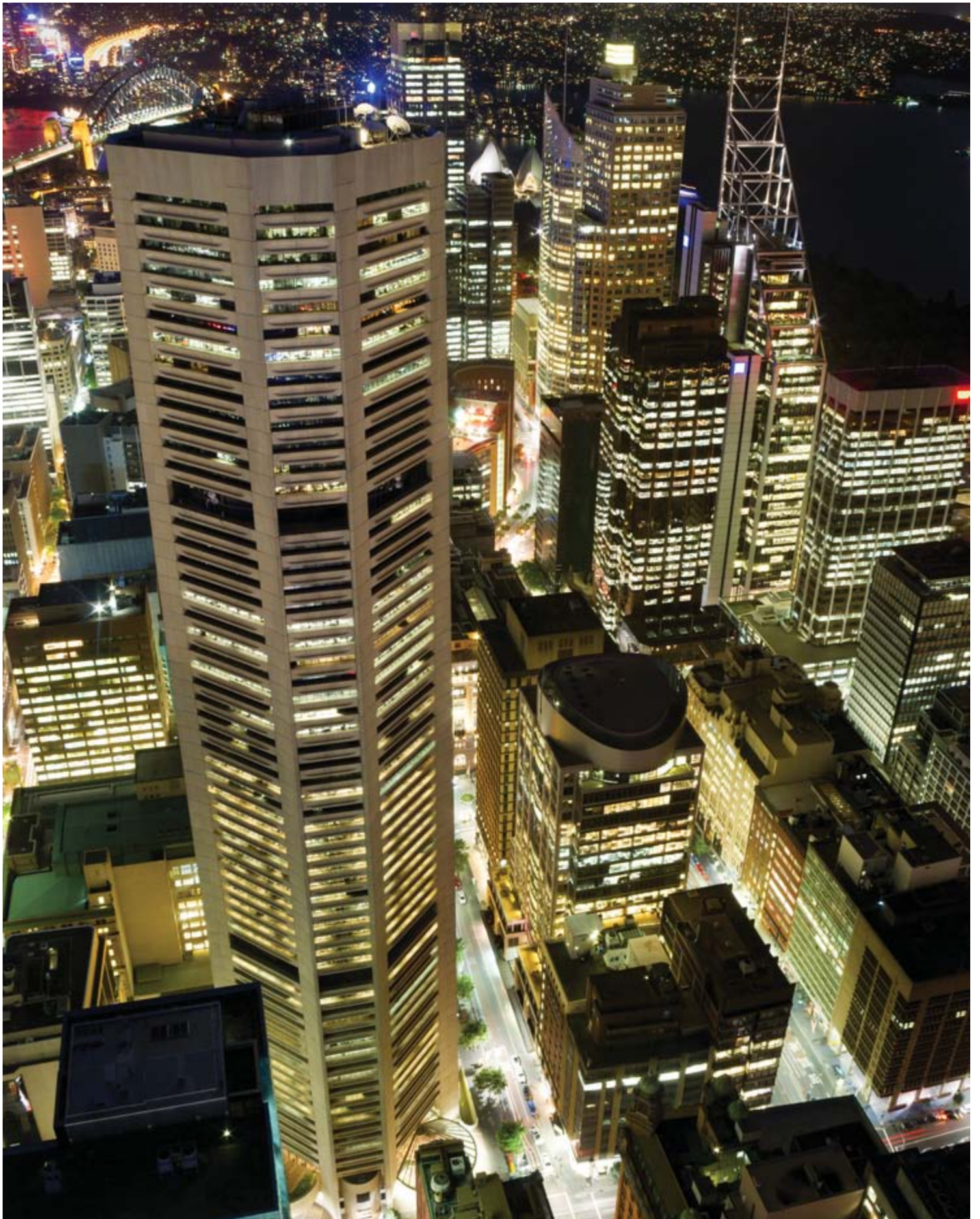
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## Executive Summary

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We remain confident in the long-term fundamentals of the Asia-Pacific markets and believe the prevailing consolidation presents opportunities for investors to acquire assets.

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Investors became more cautious in late 2011 largely due to concerns over the global economic uncertainty. With little doubt, an economic slowdown appears likely for the first half of this year. The lingering European debt crisis coupled with milder US economic growth has dampened Asian exports and business sentiment. The tightening measures imposed by the Chinese authorities have filtered through the economy and could weigh on real estate occupier demand in the near-term. We have made adjustments to the rent outlook to reflect this.

Nevertheless, we remain confident in the long-term fundamentals of the Asia-Pacific markets and believe the prevailing consolidation presents opportunities for investors to acquire assets. The softer economic outlook is being offset by pre-emptively loose monetary conditions. Globally, the US, eurozone and the UK have limited options other than to continue their various forms of monetary easing in the near term. In the Asia-Pacific region, Japan, Australia and China have all entered loosening cycles and this should help safeguard the economies from a severe downturn. With the US now showing more signs of a steady recovery, we believe the prevailing economic slowdown in the Asia-Pacific region will be short-lived. Real estate occupier demand is expected to recover starting in H2 2012.

The desire for stable income is expected to continue to drive real estate investment activity in 2012. We have continued to see strong interest for prime properties in the Asia-Pacific region despite compressed yields. Looking ahead, we believe:

- Stabilized prime properties in core locations will be sought after, supporting prices despite softer income growth prospects in the short term.
- The trend to chase yield could drive a convergence of pricing across different markets in the region. For instance, yields in Australia and Japan could harden, while those in Hong Kong could expand.
- A divergence in pricing between prime and non-prime properties could be driven by the disparity in financing availability. Limited financing to properties located in fringe areas and to development projects could force weaker owners to sell, tempering pricing for these projects.

Given these expected trends, we believe the following opportunities are available to investors:

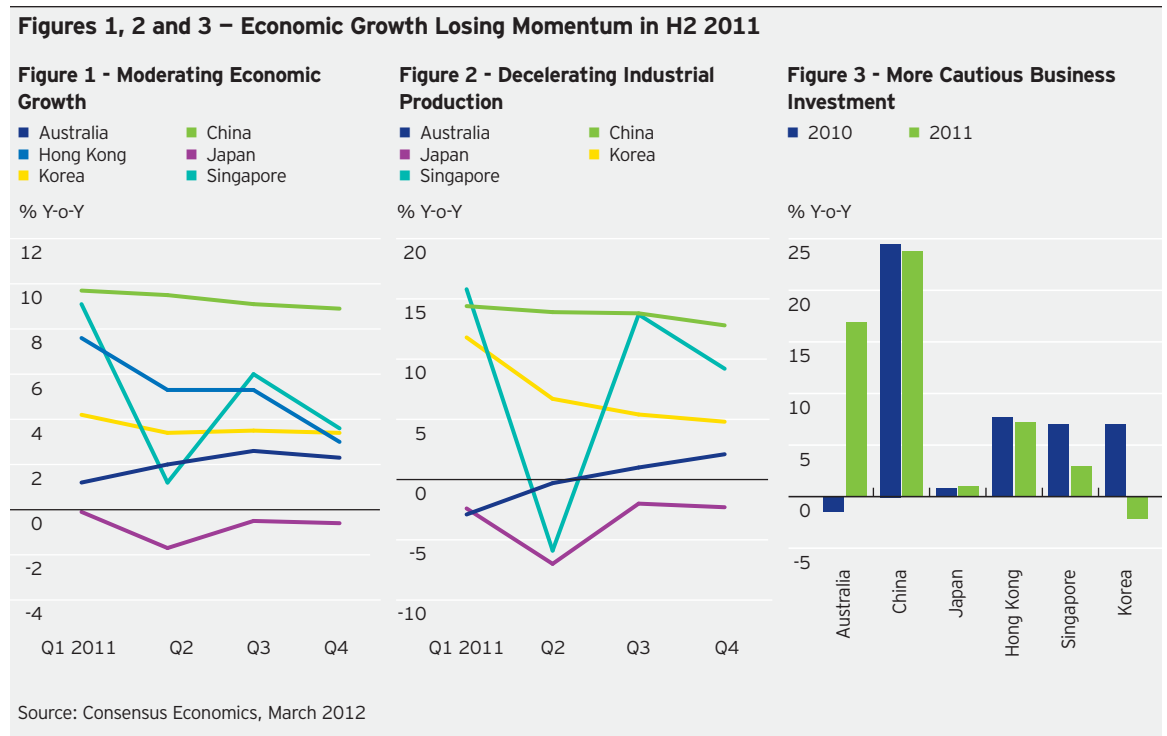
- Income-oriented investors could continue to focus on Australia and Japan. The higher income returns, positive carry and recovering leasing markets remain attractive for global investors. With a tide of equity chasing limited prime assets, investors may further consider stable, performing properties in well-established decentralized business hubs. These properties are also expected to receive favorable lending terms as domestic banks compete for business. Forward commitments to substantially pre-leased projects could also be considered.
- Investors with stronger risk appetites could target certain gaps in the market. For example, new developments are lacking in certain markets such as Hong Kong (all sectors) and development and re-development strategies could work. In China, the tough market conditions have forced some domestic developers to the sideline and investors could target residential development projects to capitalize on the structural demand for housing at more reasonable land costs.
- There is a funding gap to fill. The reluctance by banks to lend to development /non-income producing projects, has provided clear opportunities to take positions in these projects either via debt or equity participation, particularly in certain markets such as China, Australia, Korea and Japan.

## Economic Conditions and Outlook

Monetary easing and the strengthening US economy are expected to help stabilize economic conditions in Asia-Pacific during the year.

### Slowdown is imminent

Global economic uncertainty stemming from the European debt crisis started to impact the Asia-Pacific economies with economic growth moderating notably through 2011 (Figure 1). Recent data have already shown a marked slowdown in exports and industrial production (Figure 2), largely due to weakened demand from the West, the softening Chinese economy and strong currency values. The severe natural disasters in Japan and Thailand also curbed manufacturing and trade activity throughout the region. In both China and Japan, trade deficits were recorded in a number of months in 2011 and early 2012.

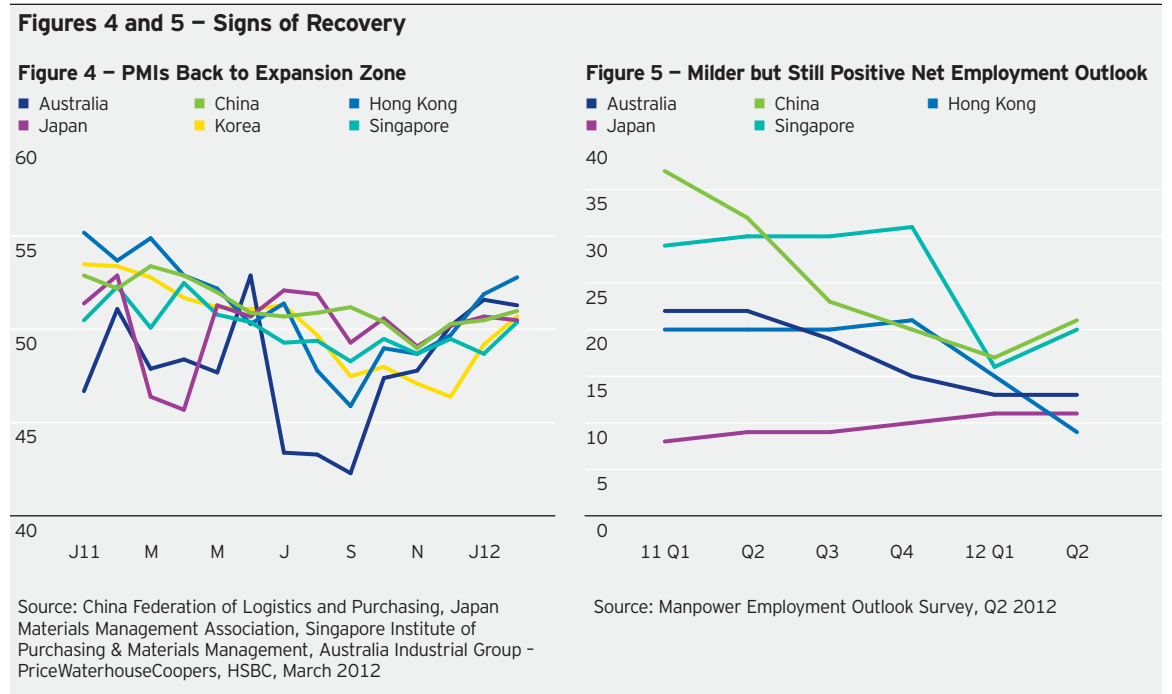


Government tightening has affected the pace of investment growth. The year-on-year (y-o-y) gross fixed investment growth in China decelerated from 30% in 2009 to 23.8% in 2011. In addition to strict controls in the real estate sector, public investment on infrastructure has also slowed, subsequent to the more cautious approach in developing the high speed rail network. In the meantime, the smaller open economies of Hong Kong, Singapore and Korea have seen declining investment levels due to their vulnerability to the global economic situation and business expansion has generally slowed. In Japan, reconstruction work after the natural disasters in 2011 drove investment activity, however, business confidence has remained fragile. In contrast, the commodity boom has supported investments in Australia (Figure 3).

Consumer confidence also moderated amidst the more cautious economic outlook and softer employment situation. Unemployment rates across key economies have edged up, led by job cuts in the financial services sector. Nevertheless, unemployment rates remain at very low levels.

## Economies likely to stabilize in H2 2012

While first half economic growth is likely to remain soft, there are already signs that conditions could improve from H2 2012. The PMIs of six key economies have started to recover from recent troughs in Q3 2011, registering above 50 (a level that indicates expansion) as of February 2012 (Figure 4). Hiring intentions have also improved, albeit marginally at the beginning of 2012 (Figure 5).



### A gradual recovery is expected to be driven by:

- A stabilizing US and, to a lesser extent, Europe

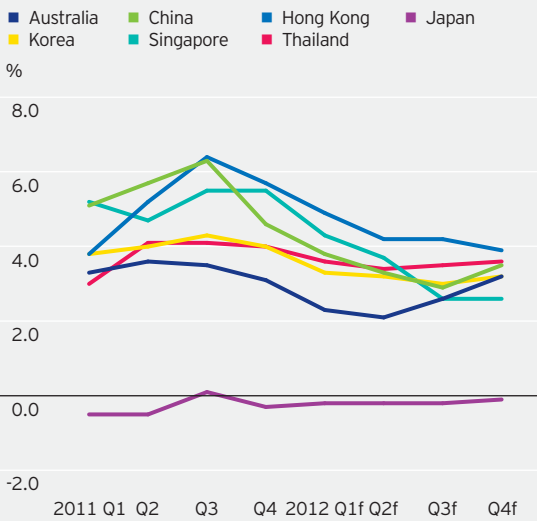
Stepping into 2012, there are clearer signs showing that the US economy is on a stronger footing. The unemployment rate hit a 36-month low in February, consumption has been more resilient than expected, PMIs have stayed above 50 and corporate profit has remained solid. These have helped to restore confidence globally. Meanwhile, although the European debt crisis continues to linger there are signs that the European Central Bank (ECB) and politicians are getting to grips with the problem and this is settling some market nerves.

- Supportive government policies

The policy stances of regional governments have already shifted to support growth. In 2010 and 2011, controlling inflation was the primary policy focus in the Asia-Pacific region except Japan. As inflationary pressure started to ease in H2 2011 (Figure 6), regional governments have more room to relax monetary policies. The Reserve Bank of Australia (RBA) cut interest rates twice since November 2011. The Bank of Japan (BOJ) has been providing monetary support since the earthquake. Similarly, the Bank of Thailand (BOT) has cut interest rates to support the post-flood recovery. In December, despite caution by the state government over a potential real estate bubble, the People's Bank of China (PBOC) lowered the required reserve ratio for commercial banks for the first time in almost three years, signaling a change in policy stance. Looking ahead, interest rates in the region are expected to remain low in the near-term (Figure 7). We believe that central banks are unlikely to move away from their accommodative monetary policy amidst the easing inflation, prevailing economic and political environment and until there are real signs of economic recovery.

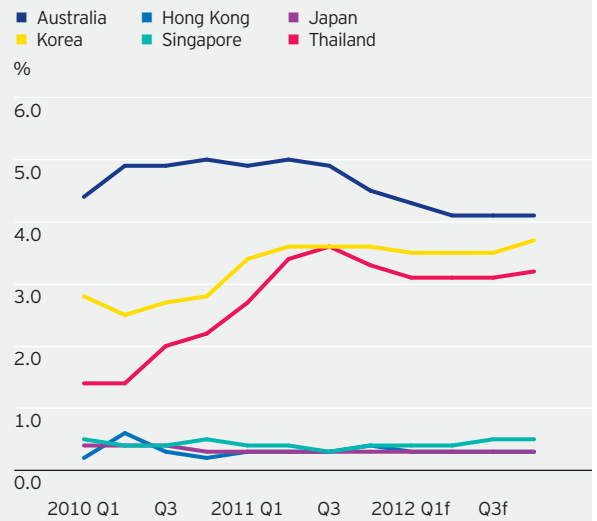
## Figures 6 and 7 – Easing Inflation Allows Monetary Loosening

**Figure 6 – Easing Consumer Inflation**



Source: Consensus Economics, March 2012  
f = forecast

**Figure 7 – Prevailing Low Interest Rate\* Environment is Expected to Remain**



Source: Consensus Economics, March 2012 f = forecast  
\*Interest rates refer to the following rates:  
Australia: 90-day dealer bill rate  
Hong Kong: 3-month HIBOR  
Japan: 3-month TIBOR  
Korea: 90-day commercial paper rate  
Singapore: 91-day certificate of deposit rate  
Thailand: 3-month deposit rate

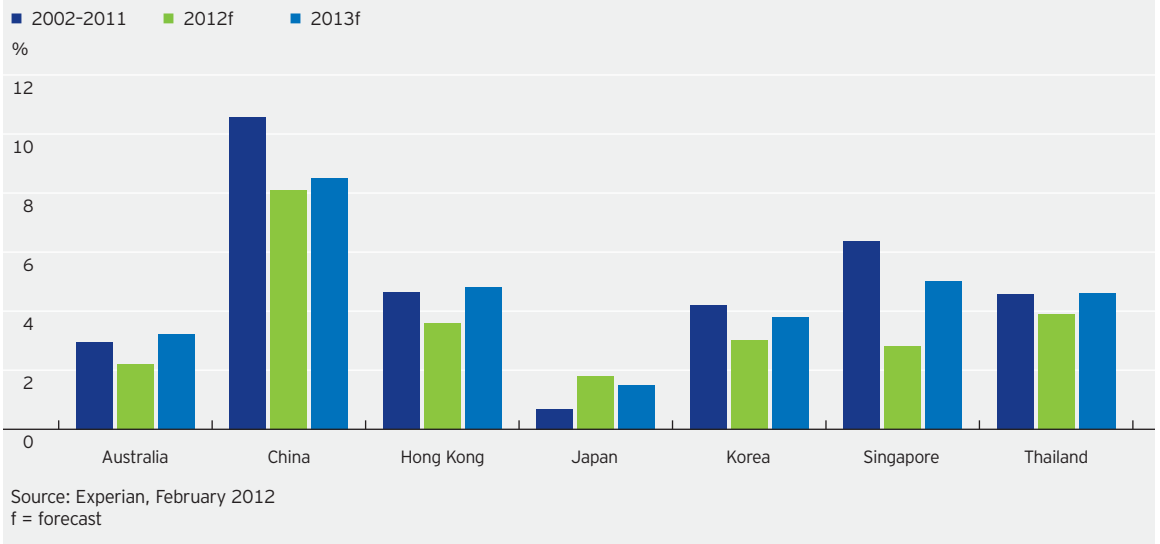
### ■ Recovering from the natural disasters

In 2011, the Japan earthquake and Thailand flood caused serious disruptions to the global and regional supply chain across a range of goods such as consumer electronics and automobiles. The damage to the manufacturing and logistics facilities constrained industrial output and exports. Yet, concerted rebuilding efforts are expected to help restore the production capacity and spur investment growth of these two countries in 2012, and are also forecast to help improve trade volumes region-wide. Recent data show a sharp increase in government expenditure in Japan in early 2012 whereas in Thailand, private investment has started to recover since December 2011.

Other domestic drivers such as strengthening intra-regional trade, solid private and public balance sheets and resilient consumers are also underpinning the Asia-Pacific economies. Broadly speaking, we expect the regional economies to have a lukewarm start to 2012 and to stabilize in the second half of the year. Overall GDP growth rates for the full year are expected to be below trend but return to their long-term historic average levels in 2013 (Figure 8).

In Australia, the commodity-led growth is expected to continue, while the RBA's easing is expected to provide further support. The Chinese economy is expected to moderate, with growth driven by more domestic consumption. We also expect the "trend" level to be lower to reflect the larger size and difficulties of sustaining double digit rates. Hong Kong, Singapore and Korea are the smaller open economies, which are more vulnerable to the global economic situation. Hence, lower GDP growth rates are expected.

**Figure 8 – GDP Forecast**



### **Systemic and macro risks remain**

While we expect the economic conditions to improve in H2 2012, it is noteworthy that our base case is based upon three key assumptions below:

#### **■ Soft landing of the Chinese economy**

We believe the Chinese economy is set to decelerate, but we do not subscribe to the hard-landing view. The deceleration is partly by intention as the Chinese government looks to transform and upgrade its economic structure. Yet, there are possibilities of unexpected disruptions. These issues may include possible social unrest due to notable wealth and income disparities, significant asset depreciation due to over-tightening of the economy / real estate markets, and sharper-than-expected downturn in the export sector due to rising business operating costs and weak global demand.

#### **■ Ordered resolution of the European sovereign debt issues**

The European sovereign debt crisis is likely to linger. Although the situation in Greece appears to have stabilized after the Long-Term Refinancing Operation (LTRO) arrangement with the European Central Bank (ECB) and the new government bond swap agreed to by private investors, it is not fundamentally solved. Concerns over the feasibility of a long-term solution, possible contagion impacting larger economies such as Italy and Spain and, more broadly, concerns about the stability of the euro could affect the overall confidence of the global capital markets.

#### **■ Gradual recovery of the US**

At the time of writing, there are more signs showing the US economy is on firmer footing compared to six months ago. Yet, the recovery appears uneven and downside risks remain. The consequences of the significant expansion of public debt and the Fed's balance sheet have to be addressed at some point in the future.

In addition, other issues including possible geopolitical conflict in the Middle East, South Sea and North Korea, and the rising systemic risks stemming from the massive expansion of global money supply all cause concern. These events could possibly renew inflation expectations and drive commodity prices higher, weighing on economic outlook and investment sentiment. More imminently, elections are approaching in a number of key countries in the world including the US, France, China (change of leadership in the government) and Australia. These may add to uncertainty as policy stances toward tax rates, public spending, global trade and currency value etc., could change. In addition, the ruling parties may be incentivized to maintain an accommodative policy stance despite being at risk of expanding public debt further, while controversial issues such as protectionism and global trade conflicts could affect the global economy.

## Real Estate Market Outlook

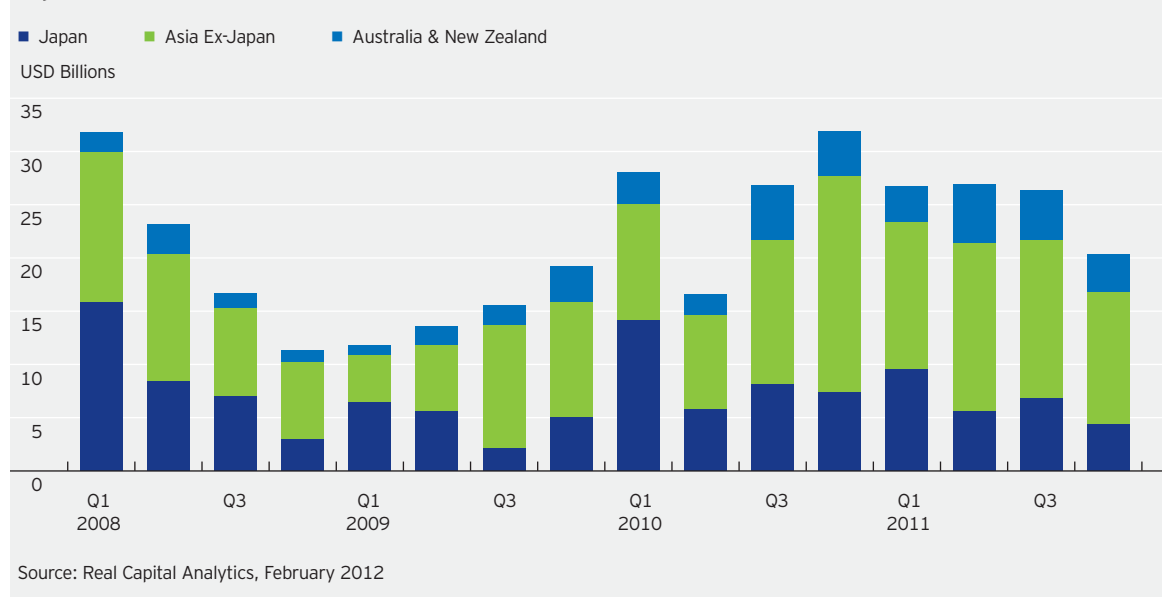
We believe the “chase for yields” amidst global monetary easing could continue to support property values. In addition, occupier demand is expected to regain momentum resulting from the anticipated economic recovery in H2 2012.

### Yield chasing continues

Monetary easing by key central banks globally has provided sufficient liquidity in the financial system and is expected to keep short-term interest rates low, and could drive them lower. Meanwhile, the flight to safety of capital has suppressed government bond yields of many major countries. As a result, real estate pricing appears reasonably attractive relative to bond yields and the cost of borrowing. In addition, concerns of possible hyperinflation as a consequence of the massive quantitative easing, reinforced by the perception that real estate is a good inflation hedge, strengthens the case for investing, particularly in the Asia-Pacific markets as the economies in this region are generally lower geared and inflation has been more apparent. The presence of a positive yield carry in most markets combined with a relatively brighter economic outlook, has strengthened confidence to invest in this region.

However, transaction volumes declined in Q4 2011 as investors were concerned about global economic uncertainties. Investment sentiment turned cautious and transaction volumes dropped as a result (Figure 9). Government tightening policies have also suppressed transaction activity in China. Yet, total transaction volumes for the whole year of 2011 still increased by 5% y-o-y.

**Figure 9 – Transaction Volumes Decline Towards the End of 2011**

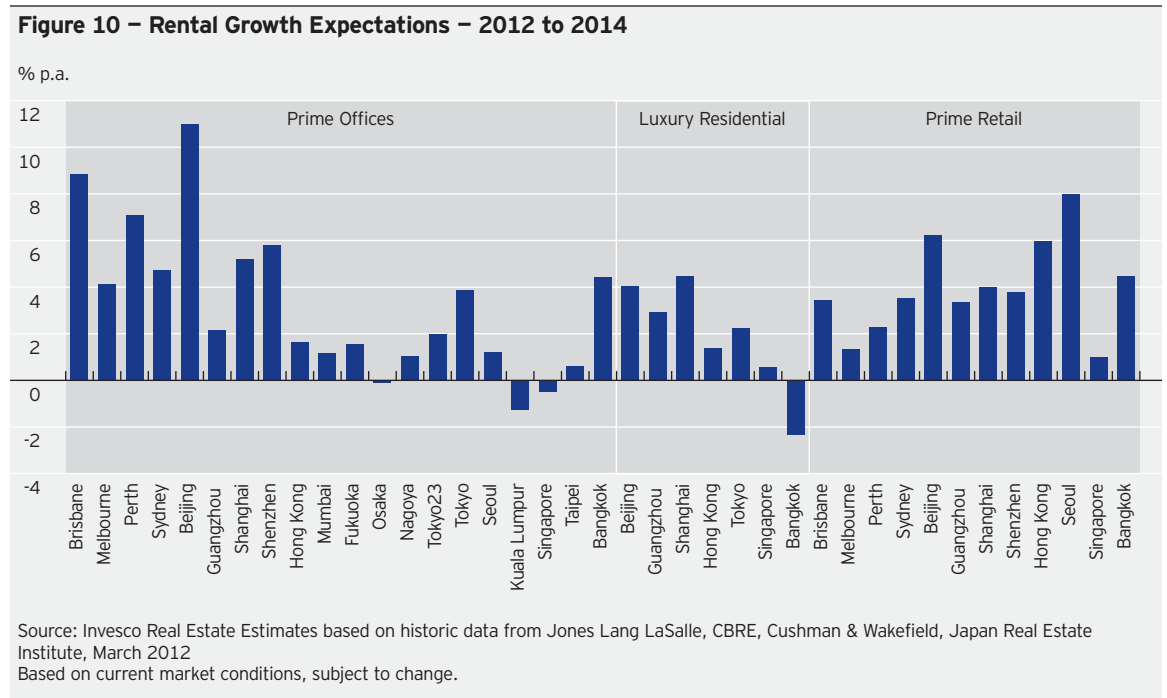


Broadly speaking, we expect the yield chase to be driven by the extended low interest rate environment and uncertain global economic conditions. We also believe:

#### ■ Prices for income-producing properties should hold up well

While investors are seeking safety and stable income, banks are also selectively willing to lend on prime properties with stabilized income in core locations, with interest rates on such loans remaining low. Prime properties showing reliable income streams and strong debt servicing abilities are expected to be keenly sought after by both equity and debt, supporting prices.

We believe the yield chase proposition is underpinned by the confidence placed in solid rental income streams derived from properties. Near-term headwinds have moderated our near-term rental outlooks in the face of the more challenging economic conditions in H1 2012. We expect 12 out of the 38 market sectors we cover to be at risk of rental decline in 2012. Nevertheless, in the medium-term three-year outlook, we anticipate that only four market sectors are at risk of rental decline (Figure 10).



■ **Divergence of pricing across different segments**

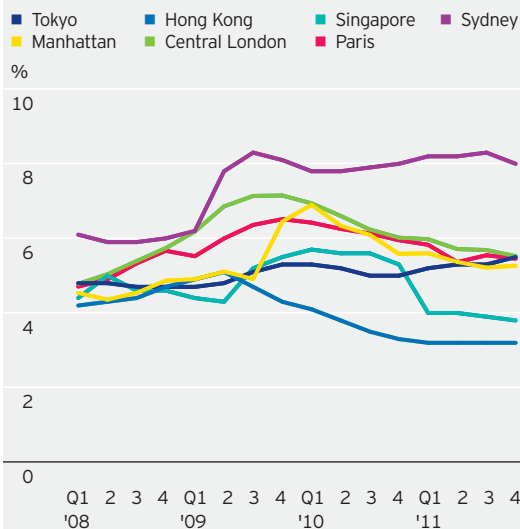
Banks’ preference toward income-producing property will support pricing. Meanwhile, banks remain reluctant to lend on poorly performing assets or for development projects where incomes are less certain. Owners of these assets could find it difficult to refinance unless they put up considerable additional equity and accept stricter terms. As a result, they may be forced to sell down at less competitive prices.

■ **Convergence of cap rates across markets**

The region is characterized by a wide range of yields across different markets. High yielding markets including Australia and Japan are expected to benefit from the yield chase trend. Yields of these two markets are high relative to other key global markets (Figure 11) and are also attractive relative to their respective historic average (Figure 12). The anticipated capital inflow, together with the improving leasing market and accommodative bank lending are expected to push cap rates lower in Australia and Japan.

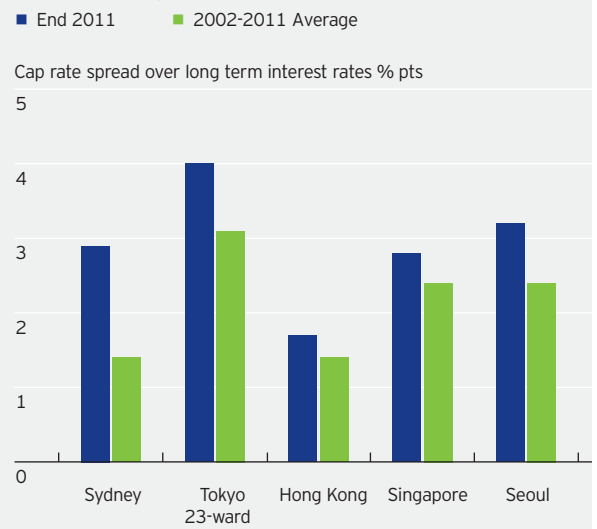
## Figures 11 and 12 – Price Arbitrage

**Figure 11 – Wide Range of Cap Rates\* Across the Region**



Source: Real Capital Analytics, February 2012  
\*Average transacted office yields

**Figure 12 – Reasonable Current Pricing vs. Historic Averages**



Source: Invesco Real Estate using data from Jones Lang LaSalle and Experian, February 2012  
Note: Data for Sydney, Hong Kong and Singapore comprises both retail and office yields. Data for Tokyo and Seoul comprise office yield only.

In contrast, yields in Hong Kong and Singapore are low in a global context and their current pricing is not more attractive than their historic averages. Hence, yields in these two markets are not expected to compress further. Meanwhile, it is noteworthy that pricing for Korean offices is becoming more reasonable. Currently, this market suffers from oversupply and current lending terms do not give any positive yield carry to investors. However, supply is expected to decline sharply in 2013 and banks' lending attitudes appear to be improving, albeit marginally. We will continue to monitor this market closely.

### Retail outperform, residential and office mixed

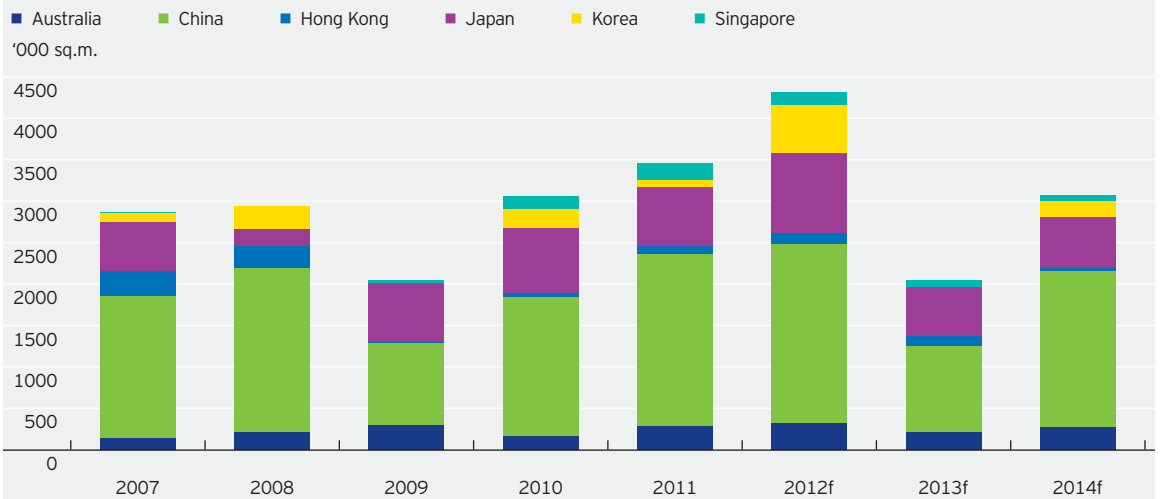
Below is a summary of our outlook by property sector:

#### ■ Office: Financial centers under pressure

The outlook for the office sector continues to be mixed. In our analysis, some office markets have seen some of the largest downward adjustments to rent forecasts, primarily resulting from their exposure to the financial services sector. Global financial hubs including Hong Kong and Singapore are likely to be more affected as major banks continue to reduce global and regional headcount, negatively impacting demand for prime offices.

Supply remains a deterrent to performance, especially when combined with moderating demand in the near term. Overall, office supply is expected to peak in 2012 region-wide, followed by a sharp decline in 2013 (Figure 13). This should support stronger rent growth starting in 2013, supported by the economic recovery. It is noteworthy that the wave of new buildings completing in 2011 and 2012 has driven a flight-to-quality among tenants in markets such as Tokyo and Seoul. Rents and occupancy in new, high-quality buildings are expected to be more resilient whereas under-managed and poorly located buildings could lose out on tenants unless landlords offer notable rental discounts and incentives.

**Figure 13 – New Prime Office Supply Is Peaking in 2012**



Source: Invesco Real Estate using historical and forecast data from Jones Lang LaSalle Research, Q4 2011  
f = forecast

Based on current market conditions, subject to change.

Notes: Australia includes Sydney, Melbourne, Brisbane and Perth; China includes Shanghai, Beijing, Guangzhou and Shenzhen; Japan includes Tokyo and Osaka; Korea includes Seoul.

Australia, Brisbane, Perth and, to some extent, Melbourne are expected to continue to benefit from the commodity boom. While in Melbourne, new supply is relatively large due to the continued development of the Docklands area, office absorption should remain robust. Meanwhile, Sydney's higher exposure to financial and related business services sectors suggests softer office demand. Nonetheless, limited near-term supply is expected to help support Sydney office rents.

In China, first-tier cities are expected to benefit from steady demand and a significant decline in new supply. In particular, we believe that Beijing could be one of the top rental growth markets in the region. New completions in both Shanghai and Shenzhen are expected to peak in 2012 and decline sharply in 2013. Meanwhile, significant supply in Guangzhou is expected to continue to limit rental growth.

The Hong Kong office market has already reacted to the weaker global economic outlook with rents declining on a quarter-on-quarter (q-o-q) basis in Q4 2011, following eight quarters of increase. While the weaker financial services sector could continue to put downward pressure on the market in 2012, the extremely limited supply in the short to medium term in the traditional business districts is expected to help drive a stronger recovery in rental rates as the economy stabilizes.

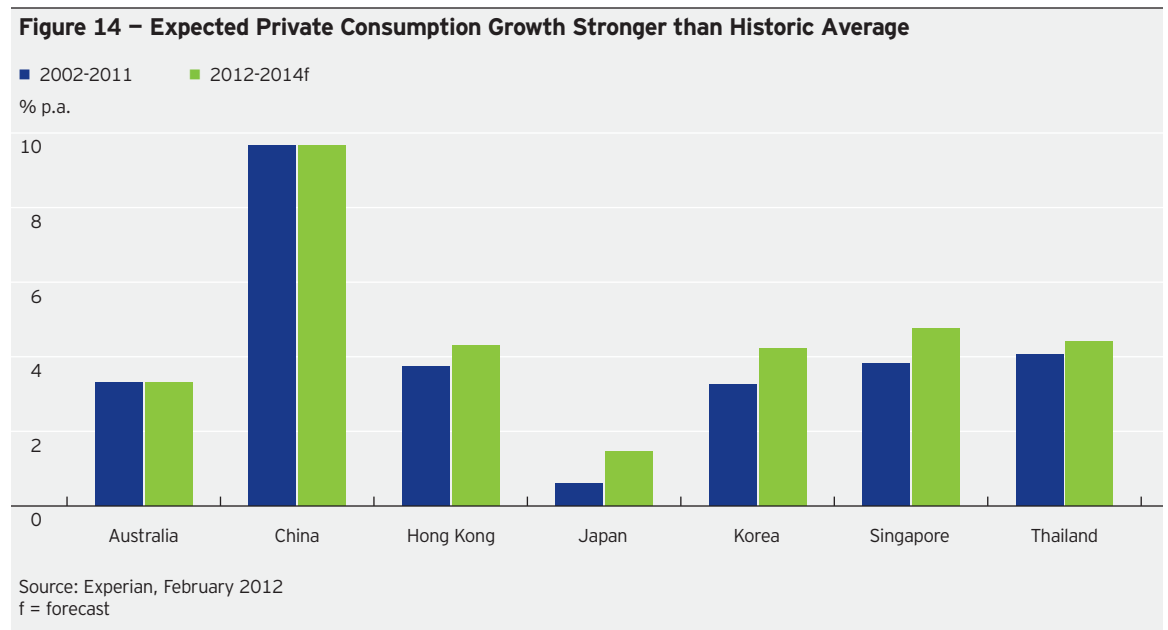
Occupier demand in Japan is stabilizing as the economy continues to recover from the earthquake. The expected completion of a number of large scale buildings near Tokyo Station could keep vacancy rates elevated in 2012. However, a flight-to-quality among tenants is expected to support the prime office segment. We expect Tokyo office rents to bottom out in 2012. In contrast, Osaka rents are expected to continue to be suppressed due to significant new supply. Meanwhile, the office markets in Nagoya and Fukuoka have been stabilizing with office demand recovering and vacancy rates starting to fall.

In Seoul, we believe that prime office rents could be close to the bottom of the cycle. Despite substantial new completions in the last few years, absorption has been solid. With new supply in 2013 expected to decrease significantly, some landlords have reportedly reduced lease incentives.

Similar to Hong Kong, demand for Singapore offices has been affected by global economic uncertainties with rents declining for the first time in six quarters in Q4 2011. However, unlike Hong Kong, new supply is expected to be substantial in both traditional prime and decentralized locations, suggesting a modest rental recovery unless the economic recovery is going to be very robust. Elsewhere in Southeast Asia, the Bangkok office market is expected to benefit from economic growth resulting from the post-flood rebuilding and limited new completions. However, vacancy rates remain high, suppressing rental growth rates.

■ **Retail: Consumption continues to hold strong**

Our confidence in the retail sector across the region remains intact. Although employment prospects have become less robust across all economies in the region, unemployment rates remain at very low levels. Consumption is expected to remain resilient with private consumption expenditure growth expected to be above-trend (Figure 14).



Consumer sentiment in Australia has remained largely subdued due to elevated levels of private household debt. In addition, the strong Australian dollar may have moderated visitor spending. Nevertheless, declining interest rates could help lift local discretionary spending.

The consumption growth trajectory in China continues. Rising disposable incomes due to economic growth, tax rate reductions and increases in the minimum wage are all supportive of private consumption. However, the slower economic growth and residential price correction may lead to milder growth rates in 2012.

Hong Kong continues to benefit from both Chinese visitors and domestic spending. The overall employment situation is expected to remain strong. Yet, we believe that consumption may moderate from the robust levels seen in 2010 and 2011 when total retail sales recorded increases of 18% and 25% y-o-y, respectively, due to moderating economic growth in Mainland China and Hong Kong.

Prime retail in Korea has performed well. Solid employment conditions have supported domestic spending, while the devalued Korean won has helped attract tourist spending, especially from China and Japan. In Singapore, the market has shown a relatively stable trend and we expect this to continue.

■ **Residential: Policy overhang remains**

We remain cautious in the residential sector due to continued government interventions in many markets in the region. In China, the government has shown no signs of relaxing its stringent purchase restrictions in the near term. Yet, with apparent price declines in major cities and stalled transaction volumes, no further tightening is expected. Meanwhile, with monetary policy gradually easing, the overall lending environment is forecast to improve. It is noteworthy that some developers have been cutting prices in order to generate sales. As a result, they are currently not in a position to aggressively replenish land banks, which has led to less pressure on land prices.

In Hong Kong, the government lowered the loan-to-value (LTV) ratio of mortgages for high-end residential purchases, imposed a special stamp duty and made more land available for small unit developments. Prices edged down slightly towards the end of last year and the total transaction volume as of January 2012 hit the lowest level in recent history. Yet, we expect this correction to be short-lived, as the growth of the Chinese economy as well as improving demographics are providing long-term support to the Hong Kong residential sector.

The additional buyer's stamp duty regulations announced in Singapore in December surprised many and signaled the government's eagerness to cool the residential market. These new rules have largely halted the high-end condominium sales market. A large volume of new completions and weaker demand from expatriates due to a slowdown in the financial services sector has also exerted further pressure on this segment. Nevertheless, the low to medium priced segments have been well-supported by local demand.

In Thailand, sentiment at the high-end condominium segment remains subdued and the upcoming new completion pipeline is expected to suppress prices. Meanwhile, the lower and middle segments are forecast to benefit from lower interest rates. Projects along the mass transit lines are expected to continue to be well-received by the market.

Japan remains an exception. Japanese residential occupancy rates have been stable and rents have also shown little volatility. The gradually recovering economy, especially in Tokyo, and limited new supply suggest that there could be minimal change to this steady trend. The stability of residential investments in Japan should continue to attract income-oriented investors.

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## Conclusions and Strategic Implications

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The Asia-Pacific real estate markets are at different stages of their cycles and offer a variety of opportunities for investors.

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### **Income: Japan and Australia show strong cash return**

Income-oriented investors could find Japan and Australia attractive given higher initial yields and cash-on-cash income after leverage. In addition, rents in these markets are either bottoming out or at an early stage of recovery. So far, investment interests have been highly concentrated in stabilized, high quality assets in prime locations of key cities, such as the core three wards of Tokyo or the prime CBD of major Australian cities including Sydney, Melbourne and Brisbane. Yet, investors should be mindful that such properties are tightly held and competition may be fierce if they come to market.

More realistically, investors could look into stabilized assets in established decentralized locations, or assets of grade B quality with solid but smaller tenants in core locations. Competition for these assets has not been as intense and banks seem to have become more willing to extend loans to these assets as well.

In Korea, the prime retail sector is expected to deliver solid income growth. Slightly higher on the risk curve, we would also selectively look at Korean offices. There could be some leasing risks at the beginning of the holding period but we expect office vacancy rates to peak and rents to stabilize this year. The current lending environment remains relatively tight and suggests limited positive carry. Nevertheless, the situation appears to be improving as banks' lending spreads were recently lowered slightly.

In China, we continue to see solid rental growth prospects in the office and retail sectors. Nevertheless, with cap rates c.4% and borrowing rates nearer 7%, investors should focus on the rental growth potential of individual assets when evaluating investment opportunities.

Meanwhile, the Hong Kong and Singapore markets offer relatively lower yields. Yet, the recent correction in the office sector may provide investors with acquisition opportunities at more reasonable prices.

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### **Value-add / Opportunistic: Exploiting gaps**

Total return driven investors could look to fill emerging gaps in the markets:

- In Japan, a substantial decline in property values since the global financial crisis forced some properties below their LTV and/or debt service cover ratio (DSCR) tests. While in many cases lenders extended loans and were willing to wait for the market to improve, a few properties were foreclosed and sold at a discount in order to recover the outstanding debt.
- Investors with a higher risk appetite could look at assets in larger regional Japanese cities. So far, both equity investors and lenders have not been focusing on regional cities, hence, cap rates are generally higher compared with Tokyo. With banks' lending attitudes continuing to improve, and the Japanese-REITs becoming more and more active in acquisitions, stabilized properties in regional cities may benefit from this weight of capital. We have anecdotally noted that some domestic banks are becoming more open to lending to investments in those cities. In addition, occupancy rates in Nagoya and Fukuoka also appear to be stabilizing.
- In Australia, banks have remained reluctant to lend to development projects. Banks normally require a high level of tenant pre-commitment and charge a high spread before extending a development loan. Some developers may therefore look for an equity partner to reduce the loan exposure, or pre-sell their project with tenant pre-commitments to reduce the cost of borrowing and lower the risk. Investors could use this opportunity to capture projects at relatively better prices.

- Similarly, development finance or lending to underperforming projects remained tight in Korea. Hence, there may be opportunities to buy from distressed owners who are not able to refinance.
- In China, the overall lending conditions remain tough. Although we expect the situation to improve gradually from H2 2012, we have continued to see developers looking to sell down by cutting project pre-sale prices, or by inviting equity partners to participate in the early stages of development. In addition, amidst the challenging operating environment, most developers do not have the capital to make residential land purchases. This presents investors with the opportunity to acquire land for residential development without facing as much competition from the usual dominant domestic players. More importantly, our confidence in the Chinese residential market remains intact. The secular trends of economic growth, rising incomes and urbanization are expected to underpin demand in the long-run.
- In Hong Kong, new supply across all property sectors is expected to be limited. Mass market housing could be a slight exception as the government plans more sites for small unit developments. With the long-term economic prospects of Hong Kong underpinned by China's robust economic growth, real estate demand is well-supported. We therefore believe that development or redevelopment strategies should be rewarding and the prevailing market consolidation should present acquisition opportunities to investors.
- We would continue to monitor opportunities in Singapore. Demographic factors remain strong, hence well-located residential development projects could be considered.





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## Key Market Summaries

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### Australia

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Resilient demand for commodities and natural resources (particularly from China and Japan) should support growth in 2012. A surge in mining investment has helped to buoy office demand and is bolstering rent growth.

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#### **Opportunities: Deterioration in global landscape magnifies appeal of steady returns in Australian commercial markets**

- Income-oriented investors could find the high initial yields and expected rent growth attractive. Office demand in Brisbane and Perth is concentrated in mining-related industries and should register the strongest take-up and rent growth rates. The Sydney and Melbourne office markets are more broadly diversified in finance and mining-related services, leaving them more vulnerable to global headwinds, but moderate rent gains are still expected due to resilient economic growth. Meanwhile, the more restricted availability of development finance could present opportunities for investors with higher return targets to acquire development projects or make forward purchases.
- The outlook for the Australian retail market is less robust as consumer sentiment remains lukewarm despite steady employment and economic growth. Declines in overall housing prices and high household leverage continue to spur household savings and keep retail sales lackluster. Marginal rent growth and investment returns are expected through 2012.

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#### **Macro Themes: Near-term growth subdued by global headwinds; Medium-term outlook suggests traction gaining in 2012**

- The Australian economy continues to be driven by the mining sector and supporting professional services. A pickup in industrial production and financial services was recently recorded in non-mining states. While annual GDP growth accelerated in the middle of 2011 following the natural flooding disasters, the year ended on a soft note with a number of economic indicators losing momentum. Consumer confidence and retail sales weakened and new housing starts sagged. Domestic consumption is forecast to be below trend in 2012 as households continue to deleverage despite rising wages.
- Benign inflation has given the RBA room to ease monetary policy despite reducing the policy rate twice since November 2011. Yet, the RBA is expected to prudently hold interest rates until there is further clarity in the global economy or in case domestic demand deteriorates.
- Looking ahead, Australian economic growth should continue to be supported by a strong pipeline of mining projects filtering across to other sectors. Despite concerns of a falling commodity price index, growth is underscored by steady resource demand and an extensive investment pipeline. The biggest risk is a hard-landing in China and any pullback in commodity demand that would result. Nevertheless, China and Japan remain Australia's top export markets and both countries are expected to remain resilient this year. A moderate pickup in economic growth is expected for the full year.

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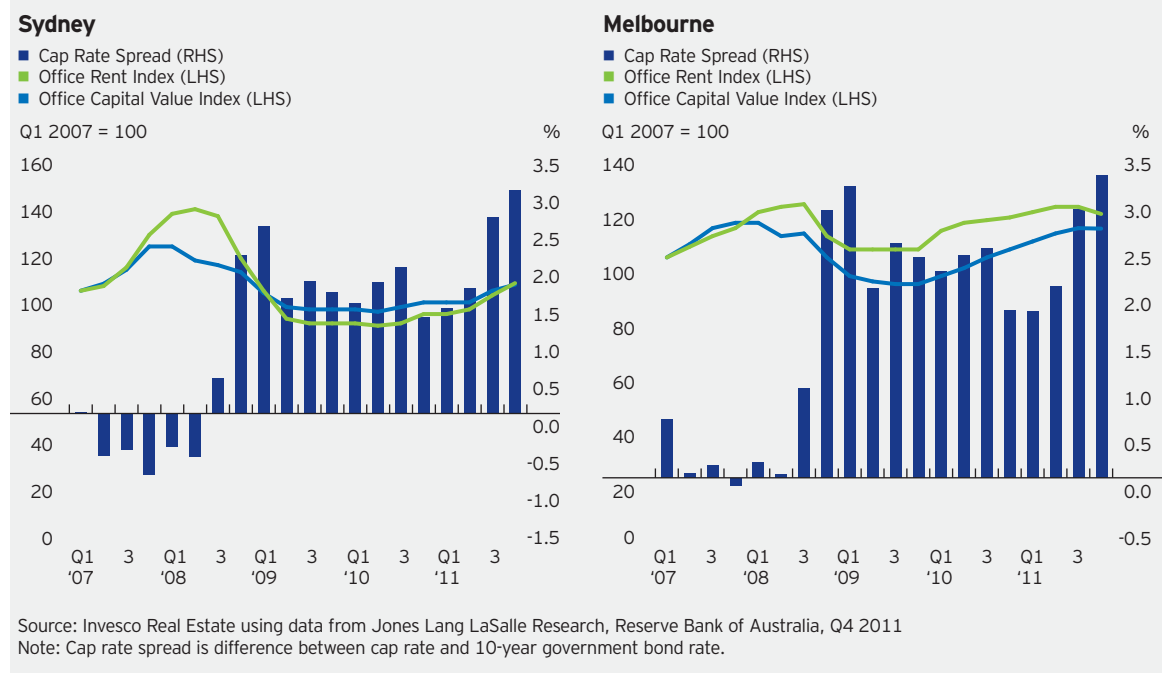
#### **Real Estate Market Update: Early upturn in office market cycle; steady retail performance**

- In the office market, leasing demand remains underpinned by new investment from resources and mining companies which, in turn, is driving expansion for financial institutions and service providers. Generally, low vacancy rates have helped to push rents higher. Looking ahead, while a moderate number of new completions are forecast, strong pre-commitment rates should help buoy the market and support solid rent growth over the next few years. Jones Lang LaSalle estimates

that nearly two-thirds of space currently under construction has been pre-committed across the major office markets. In 2012, a modest supply pipeline is expected in Sydney and more extensive pipelines are forecast for Perth and Brisbane. Nevertheless, expansion of the mining sector should drive stronger rent growth in Perth due to its current low vacancy rate.

- A key risk going forward is the volatility in the global financial markets negatively impacting office demand. In particular, the Sydney office market is largely driven by financial and banking operations. The resource-dependent markets of Perth and Brisbane should be more immune and continue to record strong net take-up. As a result, we expect continued recovery and a steady upswing through 2012 to 2013. We expect annual net effective rent growth in Sydney to average around 6% over the next three years.
- In the retail sector, performance has been marginally positive as discretionary household spending was tepid through most of 2011 with economic uncertainty weighing on consumer sentiment. The high savings rate, household deleveraging and subdued tourism continue to weigh down the retail sector. Looking ahead, generally limited new completions should keep vacancy levels relatively stable over the next two to three years. Mild rent growth is expected across major markets as we expect consumption drivers to hold steady.
- In the capital markets, we expect yield-seeking activity to continue to drive a robust investment environment. The current upturn in the office market cycle and accompanying rent growth continues to attract domestic and offshore investors. Falling bond rates have driven cap rate spreads to recent highs and provided further room for cap rates to harden (Figure 15). The Australian market's high transparency, resilient economic growth and strong local fundamentals combined with high income yields are expected to continue to attract foreign investors, particularly in a global low growth, risk-averse environment. Australian prime office assets are perceived as a safer, defensive investment and yields are forecast to mildly compress over the next two years.

**Figure 15 – Positive Cap Rate Spread And Rent Growth Supporting Real Estate Investment**



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## China

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China's economy is forecast to weather through the global slowdown, underpinned by domestic demand growth and government support. While residential returns hinge on possible policy easing, the commercial markets are expected to perform steadily.

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### **Opportunities: Commercial sectors anchored by resilient macro trends; pent-up demand accumulating in residential market but investment timing and returns hinge on policy**

- We continue to favor the office sector in Shanghai and Beijing which should remain resilient despite cautious business sentiment and prevailing external headwinds. We forecast moderated economic growth to still translate into healthy rent growth and investment returns for first-tier cities, with the exception of Guangzhou where oversupply continues to persist. Income-oriented investors could target stabilized assets strategically located within established office districts with declining new supply and solid rent growth prospects. However, investors should be mindful that borrowing costs are high enough to dilute returns at the initial stage of investment. Value-add and opportunistic investors could focus on acquiring under-utilized assets for refurbishment and lease enhancement or developing land sites strategically located within or along the fringe of expanding commercial areas.
- We believe the retail sector remains an attractive investment choice. While retail sales growth and job creation may moderate with the economy, the combination of rising wages, government-supported domestic demand and urbanization/urban sprawl should drive long-term retail performance. As such, we believe that well-let shopping centers located in the commercial hubs of first and second-tier cities should deliver solid income growth over the long-term. Again, investors should be aware of the negative yield carry. Opportunities to develop malls in key transport nodes or acquire under-utilized assets and undergo repositioning enhancements to improve the tenant mix are also available.
- We continue to be cautious with residential investments which remain under heightened policy control. The current restrictions are limiting transactions, restraining developer cash flows and leading to price discounts. Meanwhile, large pent-up demand continues to grow, waiting for the easing of the policy cycle. Total return driven investors could target distressed assets and land sites from developers and local governments.

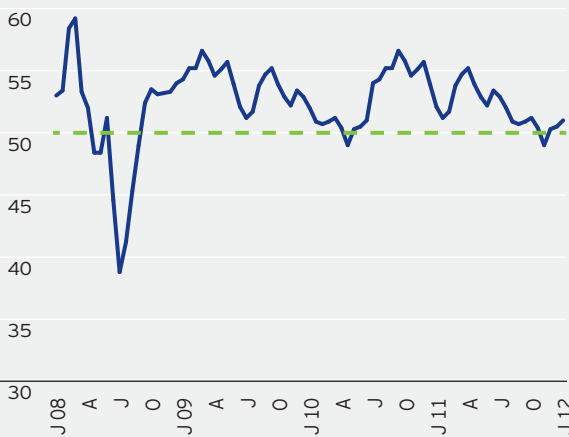
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### **Macro Themes: Easing inflation providing room for tackling softer exports and property slowdown**

- China's GDP growth is forecast to moderate in 2012 with the eurozone debt crisis weighing on demand for exports and PMI indicators signaling slower industrial production (Figures 16 and 17). Meanwhile, cautious investment sentiment, the ongoing property slowdown and the more cautious approach to develop the high speed railway network are stalling construction activity and investment growth. Nevertheless, China is expected to avoid a hard-landing. Dependence on western export demand continues to diminish with rising intra-regional trade and domestic consumption underpinned by urbanization. An emerging middle class is also driving a more diversified economy. Further government ammunition for fiscal stimulus and monetary loosening bolsters China's downside scenario.

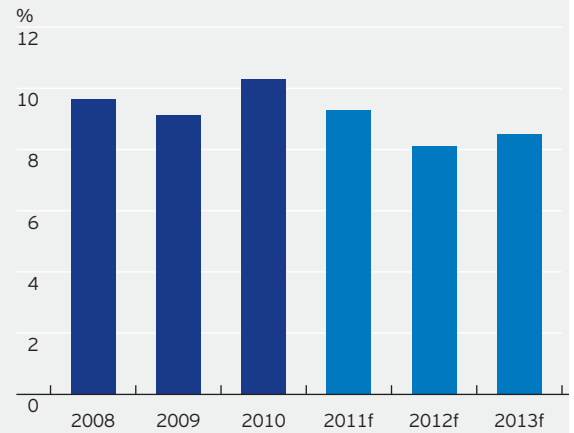
## Figures 16 and 17 – Slower Growth Outlook But A Hard-Landing Should Be Avoided

**Figure 16 - Stabilizing PMI**



Source: Bloomberg, China Federation of Logistics & Purchasing, February 2012

**Figure 17 - Softening GDP Forecast**



Source: Experian, February 2012  
f = forecast

- As the Central Government unwinds the excessive lending and fixed asset investment made in 2008 and 2009, monetary conditions are expected to remain tight with higher capital costs and restricted loan growth. Premier Wen Jiabao recently reemphasized the need to uphold policy tightening and to deflate property prices to reasonable levels. In particular, investment in social housing projects is targeted to complete five million units in 2012.
- Looking ahead, China's economic growth is expected to moderate to 8.1% this year before recovering back to 8.5% in 2013. Key risks lie in policy tightening leading to a rising number of non-performing loans and the likely consolidation of property developers. Some developers remain cash-strapped and are seeking to increase project cash inflows. With local governments also relying on revenue from land sales, selective policy easing should become more prevalent in the H2 2012. Easing inflationary pressure has also allowed room for further cuts to the reserve requirement ratio, allowing additional capital for bank lending.

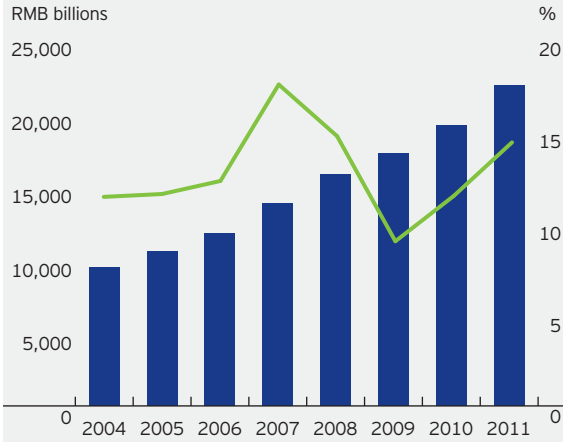
### **Real Estate Market Update: Commercial real estate is attractive; Residential weighed down by strict policy control but increasing pent-up demand**

- The office sector slowed at the end of 2011 with occupiers cautious about a deteriorating global economic environment. Nevertheless, full year 2011 rent performance was above-trend and particularly strong across all first-tier cities. In the past few years, threats of oversupply and vacancy risks have been largely alleviated by strong take-up, particularly in prime buildings in Beijing and Shanghai. Looking ahead, cautious but resilient tertiary sector growth from state-owned enterprises and foreign multinational companies are forecast to support office demand.
- The retail sector remains buoyed by healthy retail sales and aggressively expanding retailers. Urbanization, rising disposable incomes and government policy continue to underscore consumption fundamentals (Figure 18 and 19). Some prime retail landscapes are being actively upgraded with ongoing development and asset enhancement such as in Shanghai, Guangzhou and Beijing. International retailers and luxury brands continue to expand and open flagship stores. Looking ahead, with the exception of Shenzhen, we forecast first-tier vacancy rates to trend below historical levels over the next three years, supporting average rent growth between 3% to 5% per annum.

## Figures 18 and 19 – Rapid Income Growth Supporting Retail Spending

**Figure 18 - Average Annual Urban Disposable Income**

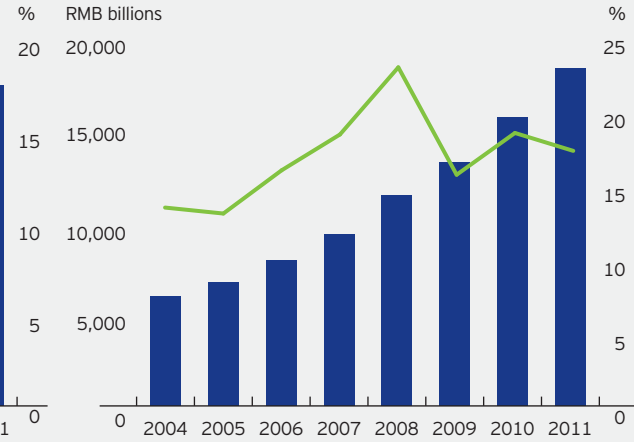
■ Average Disposable Income (LHS)  
■ Y-o-Y % Growth (RHS)



Source: China National Bureau of Statistics, February 2012

**Figure 19 - Total Retail Sales Value**

■ Retail Sales Value (LHS)  
■ Y-o-Y % Growth (RHS)



Source: China National Bureau of Statistics, February 2012

- Residential prices are continuing to correct in the midst of heightened government restrictions across home purchasing, pricing and mortgage lending. The impact of further expansion of the property tax (already imposed in Shanghai and Chongqing) to major residential markets such as Beijing followed by Guangzhou and Shenzhen, remains to be seen. Low transaction volumes and minimal cash flows are forcing some smaller/medium-sized developers to unload inventory at deeply discounted prices. Meanwhile, pent-up demand continues to build from upgraders. On a brighter note, banks are allowed to provide preferential terms to assist first-time home owners.
- Looking ahead, the turning point in the market correction is likely to hinge on the government's policy stance toward economic growth. Should GDP growth falter, we would expect policy easing to interject and be more prevalent in H2 2012.
- In the capital markets, investment activity is likely to remain robust and weighted toward the commercial sector. Investment demand from state-owned enterprises, offshore investors and institutional investors continue to focus on markets with relatively stronger rent growth prospects. While residential lending is tightly regulated, bank attitudes are more moderate and neutral to the commercial sector. Office and retail yields are forecast to edge downwards, compressing by 10 to 30 basis points over the medium term.

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## Hong Kong

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Contractions in the financial sector coupled with slowing growth in China are forecast to dampen investment returns in 2012. The retail market is forecast to perform resiliently, while corrections in the office and residential markets should be mitigated by the government budget stimulus, low interest rates and limited new supply.

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### **Opportunities: Steady retail performance; Medium-term horizon for office and residential investments**

- We believe that the fundamentals of the office market remain strong despite the prevailing market correction. New office supply located in Central is expected to remain extremely limited over the next five years. Large-scale master plan developments, such as the designation of Kowloon East as Hong Kong's second CBD, have driven aggressive investment interest in land plots and older industrial properties. We see the Kowloon East district to be well positioned to weather an economic slowdown and provide stronger growth prospects in the medium to long-term. Core investment opportunities are available with stabilized offices in Kowloon East and well-let grade B properties around Central/Wanchai. Given the general lack of new supply in the medium-term, repositioning and development opportunities in major commercial hubs and upcoming areas near new infrastructure developments could deliver strong returns.
- The retail sector remains a mainstay investment choice. Despite bank layoffs, Hong Kong's retail sector remains underpinned by expanding international retailers and tourist-related businesses. Strong local consumption and record tourist spending are supporting record high rents at high street shops and boosting retail sales in prime shopping malls. Steady rent growth is forecast over the next 2-3 years and should provide attractive risk-adjusted returns for income-oriented investors. However, the availability of deals could be limited. Investors with higher risk appetites could target under-utilized assets in popular retail locations for refurbishment and repositioning.
- Despite a seasonal uptick in sentiment after the Chinese New Year, we remain cautious regarding the residential sector. Local economic fundamentals are quite sound but the wider economy faces downside risks from global shocks. Interest rates remain historically low, but the current very low yields could be highly sensitive to even minor interest rates increases. Yet, limited new supply especially in the high-end segment, strong household balance sheets, as well as China economic growth should support the market in the long-term. We would focus on acquiring land and redevelopment projects in traditional neighborhoods where there is limited new supply and high demand from owner-occupiers. Investment performance is expected to be supported by a cyclical market recovery in the coming two to three years.

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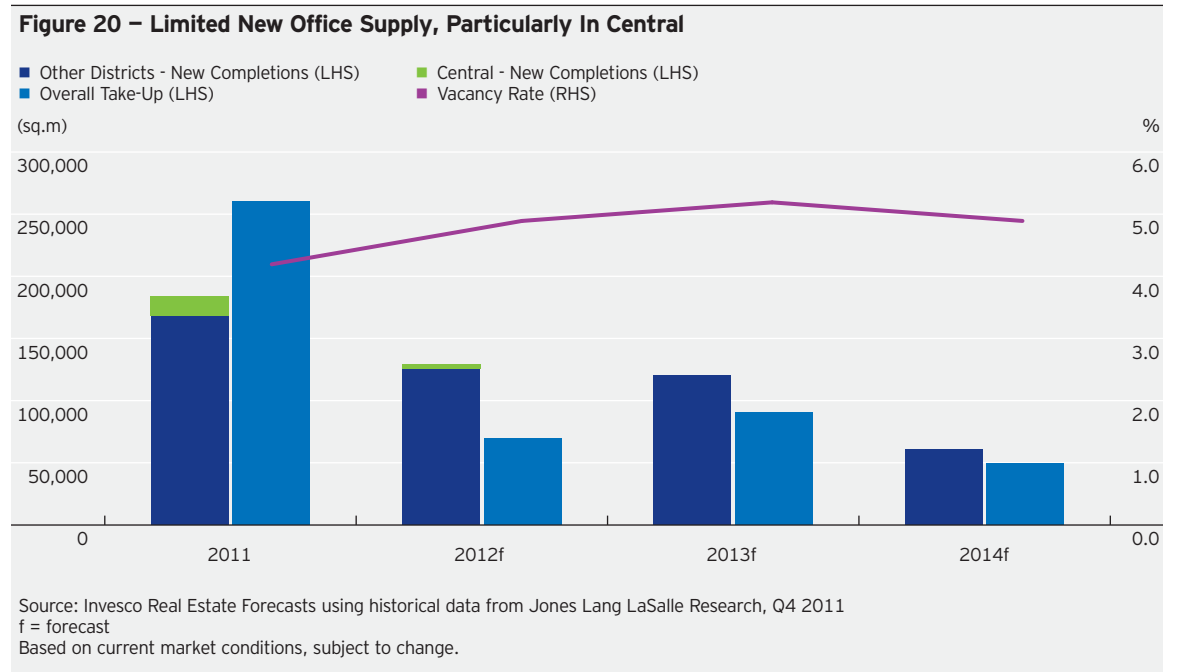
### **Macro Themes: 2012 growth dampened by China slowdown and slackened global demand but supported by local conditions; Recovery in 2013**

- The outlook for Hong Kong's economy has been steadily downgraded in line with the deteriorating global environment. Consensus forecasts for 2012 GDP growth have been revised downward from 4.9% in February 2011 to 3.0% in March 2012.
- Contraction in the financial sector has gathered momentum and further banks have shut operations and/or announced layoffs. The IPO pipeline has had a lackluster start to the year and remains subdued. Nevertheless, the labor market appears to be stabilizing with first quarter hiring expectations remaining unchanged, according to The Hudson Report Q1 2012. Non-banking sectors such as consumer goods, insurance companies and tourist-related industries continue to grow and support office demand in decentralized office districts.
- Retail sales continue to be driven largely by strong local consumption and record tourist numbers. In particular, consumer sentiment was boosted at the beginning of the year with the recent stock market rally, payout of discretionary bonuses, and the Chinese New Year holiday season.

- The recent government budget pre-emptively announced an HK\$80 billion (US\$10.2 billion) fiscal package and one-off inflation relief measures in response to the slowing economy. The government estimates the stimulus package to contribute 1.5% GDP growth this year.

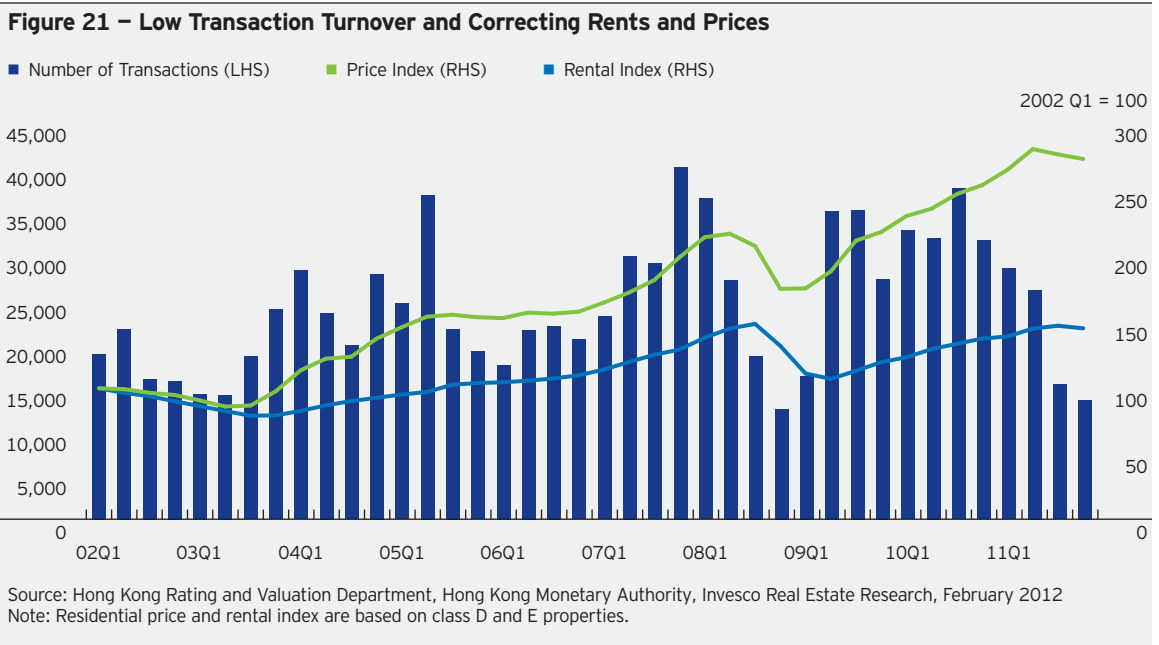
**Real Estate Market Update: Resilient retail fundamentals; office and residential correction through 2012 but brighter outlook in the longer-term**

- The office sector’s correction is stemming from a weakening in the top-tier Central office buildings. Recent contraction activity by banks and financial institutions include staff layoffs, surrendering space, waiving expansion rights and exploring lower cost relocation options. While the overall Central vacancy rate was 3.6% (as at Q4 2011), this does not reflect the recent weakness in the financial sector. Looking ahead, our rent growth forecast projects a 10% to 15% correction this year due to weak leasing demand in the finance sector. In the following two years, we forecast rent growth to recover and average around 9% per annum with new office supply remaining extremely scarce, particularly in Central where only 19,000 sqm is expected to complete in the next five years (Figure 20).

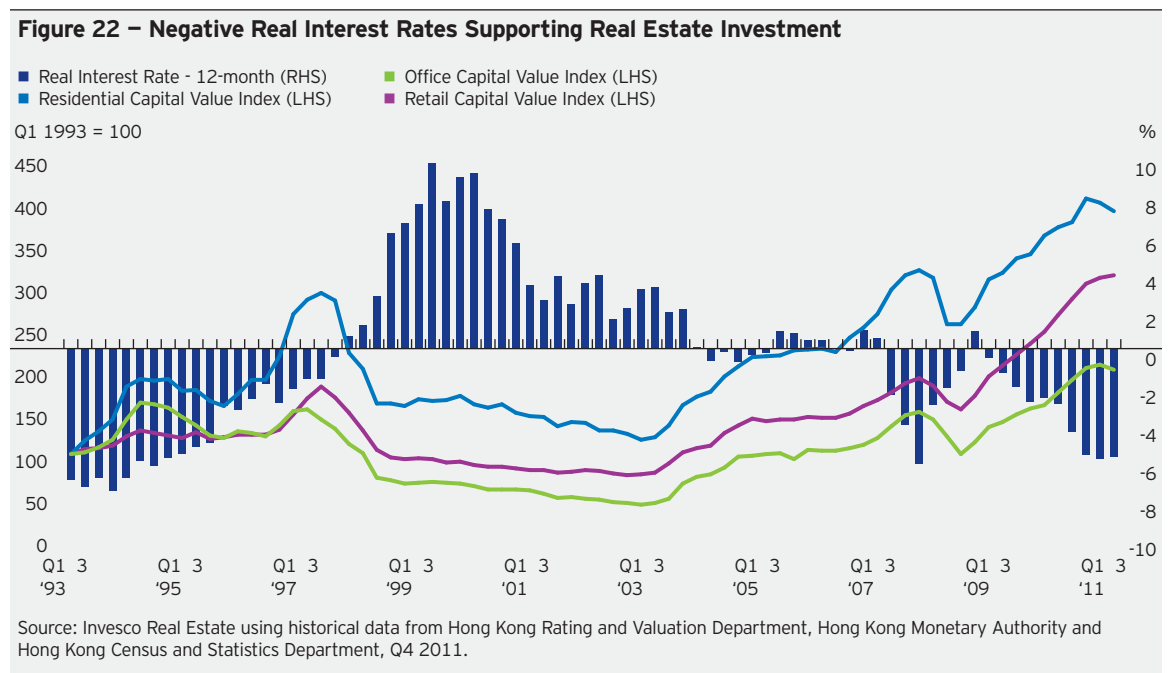


- In the retail sector, solid domestic consumption and growing spending from record tourist numbers continue to set the backdrop for retailer expansion. The Hong Kong Tourism Board expects over 44 million tourists to visit in 2012, a 5.5% y-o-y increase. In particular, Mainland Chinese tourists comprise roughly two-thirds of all tourists and continue to spend robustly on watches, jewelry, fashion and cosmetics. The demand has facilitated new openings and expansions from brands such as Rolex, Burberry, Swarovski and Apple. While there will be falling new supply in core areas, relatively ample new completions will occur in decentralized locations. Rents are forecast to rise steadily from persistent demand and tight vacancy, albeit at slightly slower rates compared with the recent past, due largely to the moderating Chinese and Hong Kong economies in the near-term and high absolute rent levels.
- The residential market has largely cooled following the government’s anti-speculation measures and the weakened global economic outlook. Transactions in the residential market slowed to levels last seen in the global financial crisis in 2008 (Figure 21). The government’s cap on LTV ratios has also stifled the high-end market, particularly stalling upgraders. Amidst the subdued sentiment, some developers have reverted to price discounts and higher sales commissions to promote

project launches, while other developers are holding back pre-sales until sentiment improves. As a result, rents and prices edged down in Q4 2011. In response to the tight vacancy and limited supply situation, the government recently identified future land sites, mainly located in suburban locations, to boost supply. These sites should have little impact on the luxury market but could dampen growth in mass projects with small units.



- Negative real interest rates and positive carry continue to drive investor demand for real estate (Figure 22). Banks have loosened mortgage terms by providing lower effective mortgage rates and increasing cash rebates. The extension of the US near-zero interest rate policy should continue to bolster low holding costs and mitigate any sharp correction in the near term.



- Investment activity remains shifted from the residential sector to the office and retail markets due to the Special Stamp Duty Tax. While REITs and local/Mainland Chinese investors are active at acquiring strata-titled office units and hotels in good locations, some developers have chosen to divest non-core assets to replenish cash and help expand land banks. Competition for prime retail properties remains intense.
- Despite keen investment interest, the economic slowdown, declining rentals and risk of rising interest rates should lead to office and residential yields slightly expanding and we forecast cap rates to edge outward 5 to 15 bps this year before stabilizing in 2013. On the other hand, we forecast resilient retail fundamentals to continue attracting investment demand with yields edging slightly lower by 10 to 20 bps in the next one to two years. Over the longer-term, we expect normalizing interest rates to limit upside in capital values but the office and retail markets should still perform solidly, although below-trend.

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## Japan

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The Japanese economy is on track for a moderate recovery. Stabilizing occupier demand and favorable capital market conditions are expected to attract investors.

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### **Opportunities: Tokyo office and residential offer strong income returns while distressed opportunities remain available**

- We expect the Tokyo office market to deliver solid income returns as new supply peaks and demand stabilizes in 2012. The favorable capital market conditions are also expected to enhance liquidity and add to returns. The prime segment of the market within the core three wards (Chiyoda, Chuo and Minato) is expected to recover faster than the rest of the market as a result of the flight-to-quality trend among tenants.
- Nationwide, the residential market has been stable with high occupancy rates and steady income returns. The Tokyo residential sector is also well-supported by improving demographic trends.
- Opportunities to acquire financially distressed assets remain available. Banks continue to selectively foreclose on non-performing loans. Asking prices for these assets are usually below-market.
- We would selectively look at opportunities in the regional cities. The Osaka core office market (two core wards of Kita and Chuo) will face strong competition from significant new completions in 2013 and rents are expected to decline until 2014. In contrast, the Fukuoka office market appears relatively attractive with limited new supply, stable demand, and the completion of the high-speed rail project leading to the local economic revitalization.

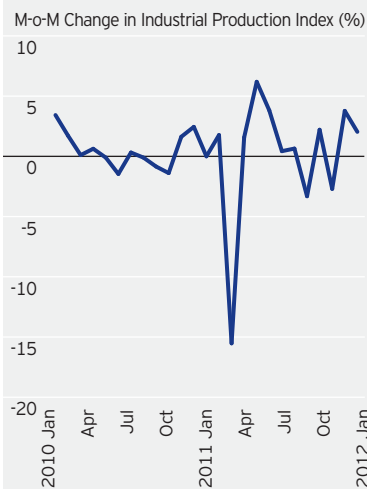
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### **Macro Themes: Economic recovery gaining traction in 2012**

- The recovery of the Japanese economy moderated in Q4 2011 as a result of the slowdown of the global economy due to the European debt crisis and the appreciation of the Japanese Yen. In addition, the catastrophic Thailand floods in late 2011 disrupted exports and factory output for major Japanese automobile, metals and machinery manufacturers. According to the second preliminary release by the cabinet office, real GDP fell 0.2% q-o-q in Q4 2011 and full year 2011 real GDP contracted 0.7% y-o-y. Furthermore, the volume of exports fell by 9.3% y-o-y in January 2012, registering four consecutive months of decline with a trade deficit of JPY 1.48 trillion.
- Nevertheless, there are recent signs indicating a moderate and steady recovery is underway. Domestic demand has remained relatively stable with business investment and retail sales continuing to register mild growth. In Q4 2011, private consumption and private non-residential investment increased 0.4% q-o-q (third consecutive quarter of increase) and 4.8% q-o-q (second consecutive quarter growth), respectively. Moreover, industrial production continues to gain traction with the purchasing managers' index (PMI) indicating a mild expansion of business activity since January 2012. Domestic private-sector machinery orders (excluding orders for ships, mobile phones, and orders from electric power companies) rose 3.4% m-o-m in January 2012 after falling 7.1% in the previous month. Furthermore, machinery orders from overseas rebounded a remarkable 20.1% m-o-m in January 2012, which is the fourth consecutive monthly increase (Figures 23, 24, and 25).

## Figures 23, 24, and 25 – Emerging Signs of A Moderate Economic Recovery Underway

**Figure 23 - Industrial Production**



**Figure 24 - Retail Sales**



**Figure 25 - Purchasing Managers' Index**



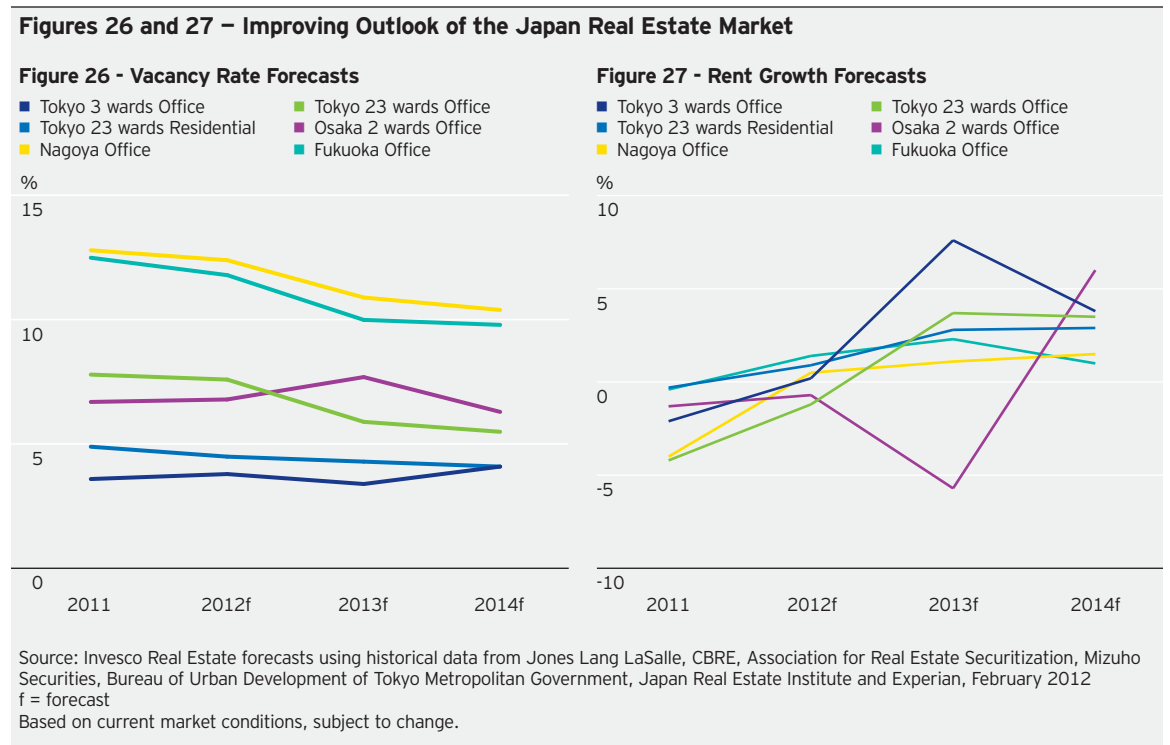
Source: Ministry of Economy, Trade and Industry, Markit Economics, Japan Materials Management Association, February 2012

- According to Consensus Economics in March 2012, full year 2012 forecasts of major economic indicators are above-trend with real GDP expected to grow 1.9%, private consumption 1.3%, business investment 4.7% and industrial production 4.8%. In particular, the recovery is expected to be boosted by the ongoing reconstruction of quake-hit areas, recovering manufacturing production after the floods in Thailand and expanded support policy from the BOJ.
- Downside risks remain notable, however. The vulnerable global economy, uncertainty as to the strength of the Japanese Yen, a possible setback of policies (e.g., sales tax increase), the ongoing electrical power constraint and rising crude oil prices could disrupt the economic recovery.

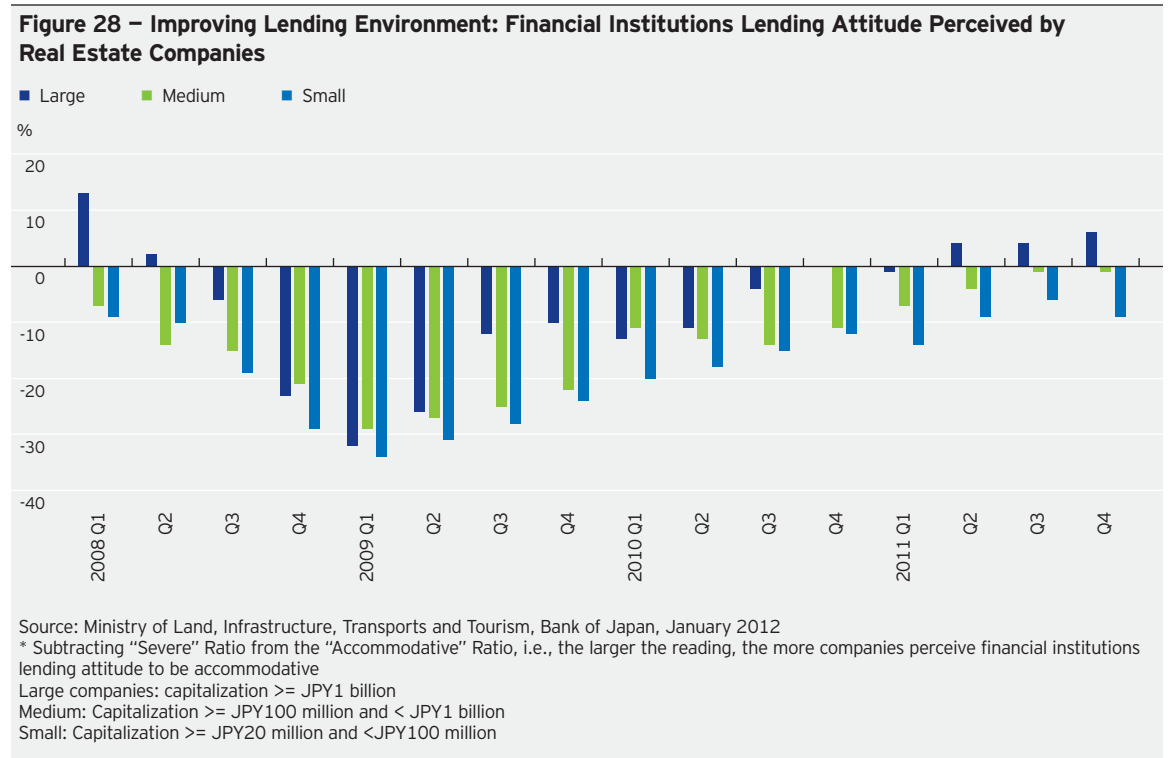
### Real Estate Market Update: Market stabilizing in 2012

- Nationwide, average office vacancy rates edged down in Q4 2011 with rents generally holding steady or edging down marginally. Meanwhile, the residential market continued to register relatively high occupancy rates and steady rents. While the Tokyo retail market was also stable, rents in most regional cities declined in 2011.
- In Tokyo, a polarizing trend among office buildings continues to be led by quake-cautious tenants seeking larger, newer, centrally-located buildings at the expense of older stock. Class-S and Class-A assets are benefiting from the flight-to-quality trend and we expect the recovery of these types of buildings to start from H2 2012 following abundant new supply entering the market in H1 2012. Nevertheless, the medium-term outlook is clouded by considerable new supply expected again in 2014. As a result, it is important to understand the micro market dynamics when investing.
- As the Tokyo office market is expected to benefit from improving occupancy and rent recovery in 2013, a variety of domestic income-oriented investors including insurance companies, JREITs, railway companies, and real estate companies, as well as foreign core funds are actively looking for acquisitions of Class-S and Class-A office buildings in Tokyo.
- The Tokyo residential market has been stable with relatively high occupancy rates and steady income returns. According to the Association for Real Estate Securitization (ARES), the average rent edged down marginally after the earthquake and rose by 1.4% m-o-m in November 2011. However, the occupancy rate in the Tokyo 23 wards has hovered around 95% since the middle of 2010, and the annual income return has largely been flat since Feb 2011, standing at 5.3% in November 2011.

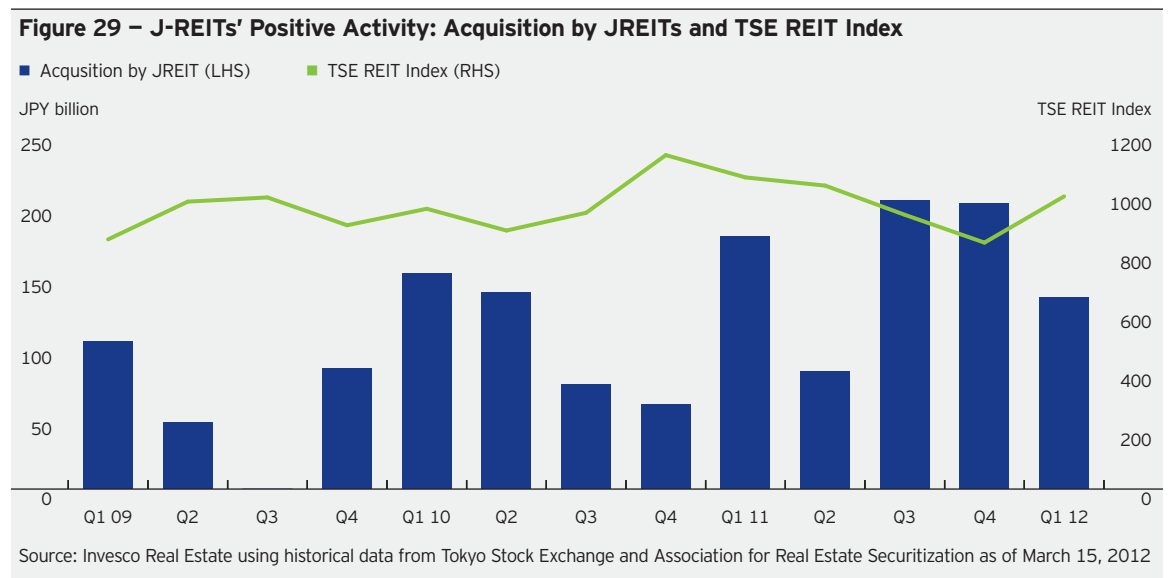
- Looking ahead, the residential market is expected to be supported by favorable demographic factors including population growth and household formation. The Tokyo metropolitan government forecasts the city population (23 wards) to grow 1.2% from 8.81 million in 2010 to 8.92 million in 2015. Furthermore, the number of households is forecast to increase by 2.9% over the same period. In the face of a moderate new supply pipeline, we expect a mildly declining vacancy rate to support gradual rent growth and for income returns to hold steady.
- Our outlook on major regional office markets is mixed (Figures 26 and 27):
  - According to Jones Lang LaSalle, the vacancy rate in the Osaka core two wards decreased 1.1% y-o-y in 2011 due to notable demand from tenants seeking larger and newer buildings. Nevertheless, we anticipate that the core Osaka office market will continue to face severe oversupply conditions through 2013 and signs of recovery shall be prolonged until 2014.
  - According to CBRE, occupancy rates in the Nagoya office market recovered in 2011 amidst restrained supply. Looking ahead, occupancy levels are expected to improve due to stabilizing tenant demand and limited new completion expected over 2013 and 2014. However, rent growth is expected to be moderate given the relatively high current vacancy rate and the anticipated larger volume of new supply in 2015.
  - The Fukuoka office market is relatively attractive. The opening of the entire Kyusyu Shinkansen has positively impacted the Fukuoka economy and attracted an increasing number of tourists from western Japan and other parts of Asia. The neighborhood immediately surrounding the JR Hakata station has specifically benefited from the increased attention of the overall market. According to CBRE, the volume of new office supply in 2010 and 2011 was extremely low, in sharp contrast to the oversupply situation in 2008 and 2009. Looking ahead, new completions are expected to remain low while office demand should stabilize and be sustained in the near-term due to improving economic fundamentals. Hence, we anticipate that Fukuoka offices will deliver relatively stronger returns among the regional cities.



- Capital market conditions are favorable for property investment given the positive yield carry and improving bank lending environment. According to the BOJ, financial institutions' lending attitude perceived by large real estate companies has continued to improve (Figure 28).



- Stabilizing rents coupled with the current high yield spread over borrowing costs and improving liquidity is expected to attract both domestic and foreign investors, driving yields down from 2012 onwards.
- Acquisition activity by J-REITs has picked up since H2 2011. The recent upsurge in the TSE REIT Index should contribute to an increase of public offerings by J-REITs, and this is expected to help improve the liquidity of the real estate market and support capital values (Figure 29).



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## Korea

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While Korea's export-led economy remains vulnerable to a slowdown in global demand, fundamentals appear resilient with low unemployment, strong tourism growth and increasing trade to Asian countries. The office oversupply situation is showing signs of improving and rents should stabilize by the end of 2012.

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### **Opportunities: Turning selective with office opportunities**

- In the Seoul office market, strong take-up has alleviated the oversupply backdrop and we expect the market to stabilize by the end of this year. In particular, the Gangnam office market should be more resilient with the majority of new supply concentrated in Yoido and the CBD. Investors could focus on newly completed buildings which could benefit from the flight-to-quality among tenants, although there could be some lease-up risk at the beginning of the investment. For higher-risk investment returns, opportunities arising from the tight financing environment for development and underperforming projects could also be explored. As noted, location remains a critical consideration for office investing.
- We believe the retail sector should perform steadily despite the ongoing global uncertainty. Strong tourists and resilient domestic spending should cushion the potential downside. Income-oriented investors could benefit from the expected positive rent reversion from stabilized assets in core retail areas. Opportunities for converting well-located underperforming offices into retail assets or developing shopping centers in tandem with a strategic anchor tenant are also available.

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### **Macro Themes: Global slowdown weighing on consumer sentiment and growth prospects**

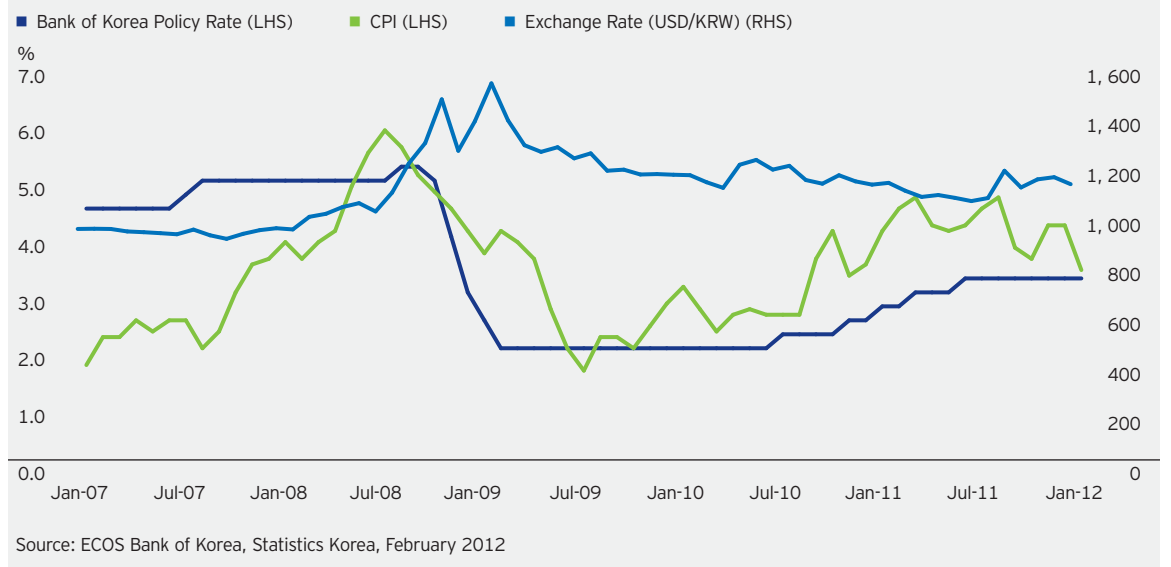
- The Korean economy continued to ease in the second half of 2011 with slowdowns registered across export demand, domestic demand and industrial production. PMI readings indicate that manufacturing activity should remain subdued in the near-term, particularly as inventory accumulates and construction investment stagnates. Nevertheless, the overall domestic economy is supported by facilities investment and steady consumption growth stemming from low unemployment, buoyant tourism spending and rising incomes (Figure 30). Retail sales remain underpinned by local spending on discretionary items such as automobiles and household electronics combined with a growing number of tourist arrivals from Mainland China and Southeast Asian countries.

**Figure 30 – Tourism Growth Underpinning Consumption**



- Easing inflation is allowing room for an increasingly stable exchange rate and benchmark policy rate despite risks associated with the ongoing Eurozone debt crisis, a subdued housing market and climbing household debt (a record high of KRW913 trillion (US\$813 billion) in Q4 2011) (Figure 31). Consumer sentiment fell for the fifth straight quarter in Q1 2012 and may remain weak amidst slower economic growth.

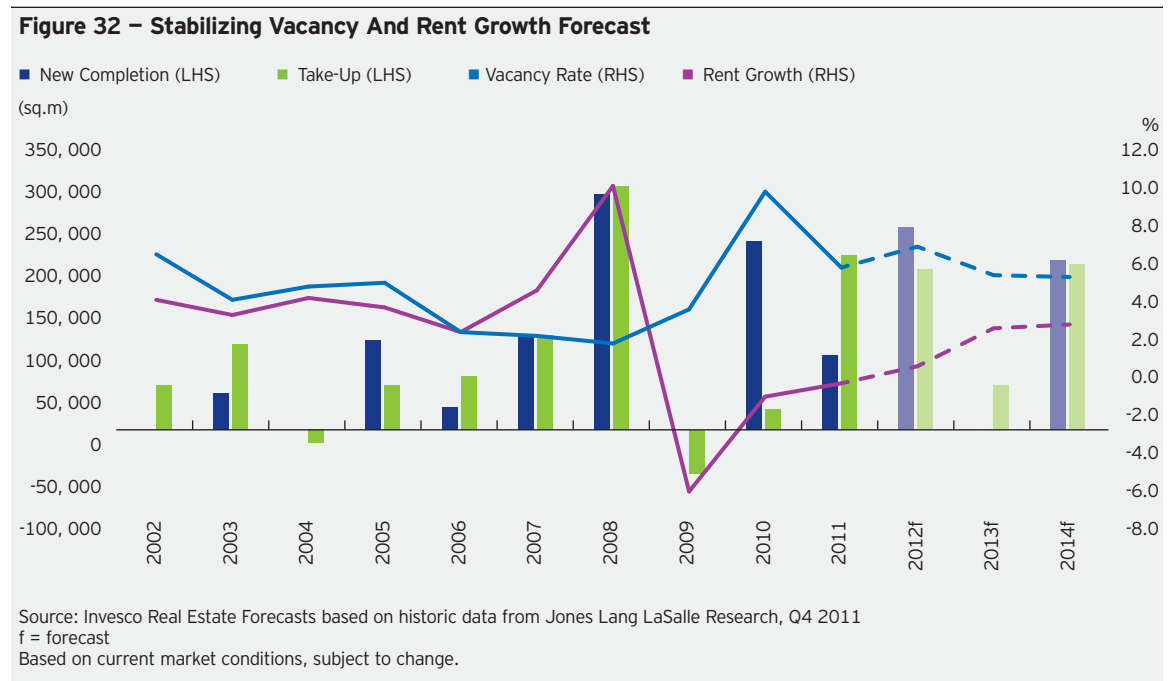
**Figure 31 – Easing Inflation Leading To More Stable Policy Rate and Exchange Rate**



- Looking ahead, the global slowdown should continue to temper exports despite the enhanced quality and competitiveness of major Korean automobile and IT exporters. Domestic demand and an ongoing construction recovery will be key supports of economic growth. In the second half of the year, policy easing in major economies is forecast to improve the outlook for exports. Consensus forecasts expect GDP growth to slow to 3.1% in 2012 followed by a 3.9% rebound in 2013.

## Real Estate Market Update: Office market to stabilize by year end with declining new supply and resilient absorption

- Seoul's extensive office pipeline continues to exert downward pressure on rents. The vacancy rate is forecast to increase above 6% this year as Seoul International Finance Center (SIFC) Tower Two and Tower Three adds approximately 240,000 sqm of quality space in Yoido. Nevertheless, new supply of grade A offices continues to register steady absorption as conglomerates consolidate into the new buildings. Seoul IFC Tower One opened in 4Q11 with approximately a 60% occupancy rate after securing tenants including Deloitte, Sony Korea and LG. Despite tenant-friendly conditions, we anticipate the office market to stabilize this year and for rents to bottom by year end as excess supply is absorbed. In addition, a sharp decline in new completions in 2013 is expected to support rents (Figure 32).



- The retail market continues to perform resiliently with buoyant labor conditions, steady private consumption and rising tourist spending amidst the global slowdown. Foreign retailers are increasingly launching their brands and seeking space to open flagship stores. Solid sales growth in department stores and big box marts combined with fixed rent escalations have helped drive marginal rent growth.
- Transaction activity continues to center around institutional office assets. Interest from domestic institutional investors for prime assets in the CBD have been strong and the total transaction volumes in 2011 reached a three-year high. In contrast, competition for value-add and opportunistic investments has intensified with distressed developers showing more willingness to dispose of assets. Nevertheless, lenders continue to prefer core products and are competing to provide favorable terms. With the Bank of Korea's policy rate holding steady amidst the heightened uncertainty, borrowing costs and subsequently, cap rates are likely to also hold steady.

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## Singapore

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The global slowdown weighed heavily on Singapore's economy at the end of 2011. However, recent signs of stabilizing export demand suggest moderate economic growth this year. Retail performance should be steady but the office and residential markets are still forecast to undergo healthy corrections this year amidst ample new supply and policy overhang.

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### **Opportunities: Position for negative returns in 2012 followed by cyclical market recovery in 2013**

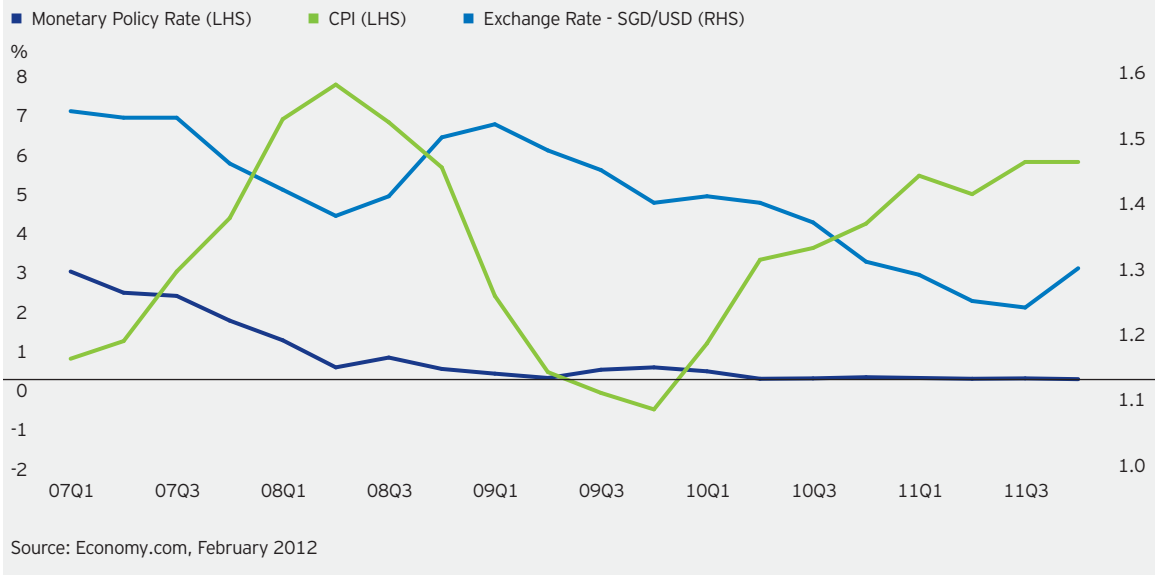
- We would be selective with the office sector due to the influx of new supply in the core areas and surrounding periphery amidst the global slowdown. We are cautious of government policy which has intentions to keep Singapore's occupancy costs regionally competitive. Given the ongoing market correction, volatile sentiment and market uncertainties, there could be opportunities to acquire undervalued assets. Investment performance is expected to be supported by a positive yield carry, cyclical market recovery and mild rent growth in the coming two to three years. Feasibility of value-add or development opportunities would be subject to metrics and fundamentals of individual investments.
- We expect the retail sector to be more resilient through the global slowdown. Local fundamentals remain well-supported by a growing population, increasing affluence and strong tourist arrivals and retail sales should register moderate growth. The retail landscape remains in transition, driven by an influx of newly refurbished and completed malls. Performance of stabilized, quality assets in traditional retail hubs would be parlayed by the positive yield carry and mild growth prospects. Meanwhile, value-add strategies such as repositioning under-utilized shopping centers, improving tenant mixes and developing quality malls in good locations are also expected to be feasible.
- We are cautious with the high-end residential market due to the policy overhang and oversupply crunch. Nevertheless, a cyclical market recovery is forecast with mild rent growth in the next two to three years. As we remain confident on the long-term population growth prospects, development could be feasible particularly in the mass and middle segment of the market in good locations near transport hubs. Fundamentals of individual assets are important in assessing these opportunities.

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### **Macro Themes: Economy weighed down by contracting financial sector and moderating external demand**

- The outlook for the Singaporean economy is challenged and constrained by moderating global export demand. While manufacturing output avoided a sharp downturn in December with biomedical production helping to compensate for slackened chemicals and electronics-related manufacturing, GDP growth forecasts continued to be downgraded. Consensus forecasts for 2012 GDP growth have been revised downward from 5.5% in February last year to 2.8% in March 2012.
- The Monetary Authority of Singapore is vigilantly monitoring the economy and is positioned for further easing despite elevated inflation levels from higher housing, food and transport costs. However, slowing signs of inflation have given more room for the currency to depreciate and for the monetary policy rate to be held steady (Figure 33).

**Figure 33 – Stable Inflation Has Allowed Room for Currency Depreciation**

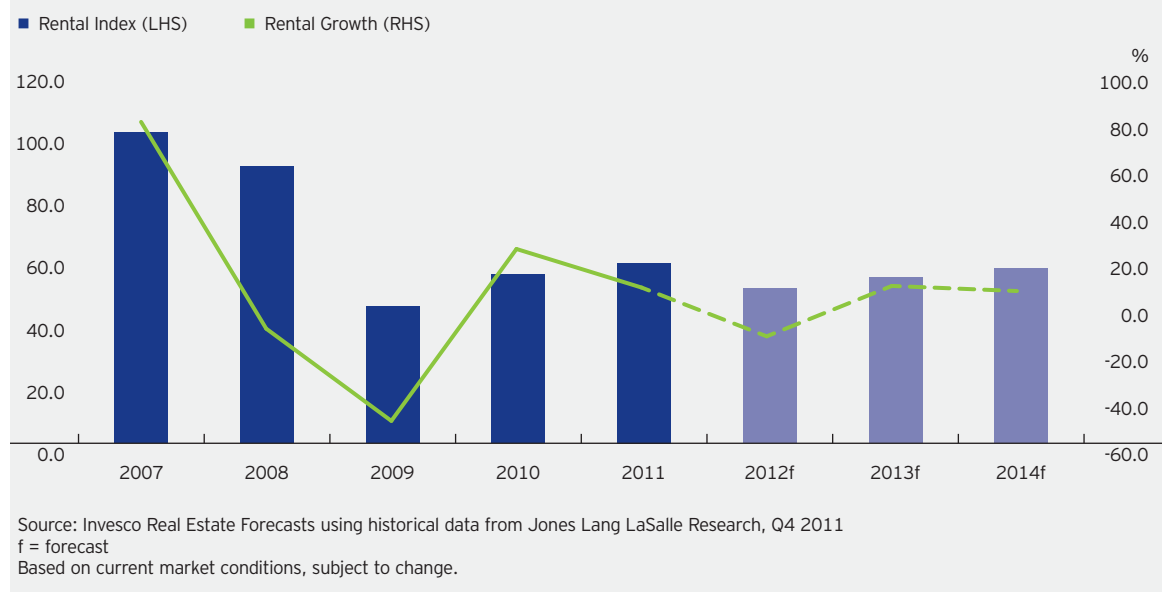


- In addition, the domestic economy remains underscored by low unemployment, resilient household spending and strong immigration growth. Retail sales remain supported by the burgeoning tourism industry with record highs in 13.2 million arrivals and S\$22.2 billion in spending during 2011. While banks and financial institutions have announced layoffs amidst cost cutting initiatives, Singapore continues to draw foreign-skilled professionals.

**Real Estate Market Update: Correcting office and residential markets in 2012; Retail forecasts stable**

- We expect the office market to correct throughout the year. Despite hiring intentions stabilizing in Q1 2012, companies especially in the financial services sector continued to cut costs and leasing activity was focused on decentralization to larger spaces at cheaper rents. With relatively ample new supply in both core and suburban locations, landlords have been aggressive, providing attractive pre-commitment packages to secure tenants. While approximately 60% to 70% of the 1.6 million square feet of new supply in 2012 is already pre-committed, we forecast rents to continue declining by approximately 10% to 15% this year. However, 2013 should be positioned for a recovery with the economic recovery gaining momentum coupled with absolute rent values still around 50% below the pre-global financial crisis peak (Figure 34).

**Figure 34 – Expected Ongoing Office Correction in 2012 Followed by Recovery in 2013**



- The prime retail market continues to perform consistently as retail demand is backed by a resilient domestic economy and rising tourist arrivals. Vacancy inched up due to new completions and is expected to rise further as more supply comes on in 2012 to 2013. Going forward, we expect the retail landscape to remain competitive with new malls and a cluster of refurbishments enhancing the retail landscape. As a result, rent growth should be generally stable over the next two to three years.
- The luxury residential sector is currently facing weak market sentiment, policy overhang and ample new supply clouding the outlook. Reduced job certainty and decreased housing allowances has led some occupiers and expatriates to downsize to smaller and less expensive properties. On the sales front, the recently enacted Additional Buyer's Stamp Duty (ABSD) seriously dampened purchases by foreigners while also forcing developers to complete and sell all units in projects within five years to avoid the 10% ABSD. A number of new projects continue to register weak sales results, particularly as investors switch investment interest to other sectors. According to DTZ, foreigners made up roughly 43% of all prime home sales (i.e. properties above S\$5 million) with Indonesians and Mainland Chinese as the top buyers. Following the implementation of the ABSD, these buyers have adopted a wait-and-see attitude and have been reportedly scouting other markets such as the US and prime European cities for investment opportunities. However, in the mass market, sales performance has been resilient for projects located near the MRT subway stations on the back of strong local upgrader demand.
- Investment activity remains buoyant with REITs, developers, local and foreign institutional investors attracted to commercial opportunities which remain unaffected by the recent government cooling measures and continue to have a positive yield carry. Banks remain keen to lend for real estate investment and low interest rates are helping to buoy investment activity. Recent government residential land tender sales continue to attract a competitive 8 to 10 bids per site as developers seek to replenish land banks. Looking ahead, while the market remains supported by the low interest rate environment and the strong balance sheets of developers, commercial yields are expected to edge up due to global uncertainty and muted rent growth prospects in the next couple years.

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## Thailand

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A post-flood recovery is forecast to spur rapid economic growth in 2012. The government remains set on regaining investor confidence which should boost the commercial property sectors. The residential sector faces near-term risks of ample supply and subdued demand.

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### **Opportunities: Positive returns in recovering office market cycle and steady retail growth; Cautious with subdued residential market**

- We expect the office sector to benefit from improving business sentiment and government support. While the vacancy rate remains at its historic high, progressive absorption should drive moderate rent growth in the medium-term.
- We believe that the retail market is underpinned by solid economic fundamentals, favorable demographic trends and a recovering tourism industry. Core CBD assets continue to receive strong interest from local property funds and developers but these assets are usually tightly held by a handful domestic investors. Total return driven investors could explore retail center developments in new areas which will benefit from the new Bangkok elevated skytrain (BTS) extension. Attractive risk-adjusted returns could also be achieved in converting older, under-managed family centers.
- We are cautious with the residential market as the ample supply pipeline currently outstrips end-user demand. Increasing inventory is suppressing rent growth and investment sentiment remains subdued. Opportunistic investors could focus on developing for the mid-end market in good locations near public transport hubs or along the new BTS extension line. We would also monitor potential distressed assets coming onto the market.

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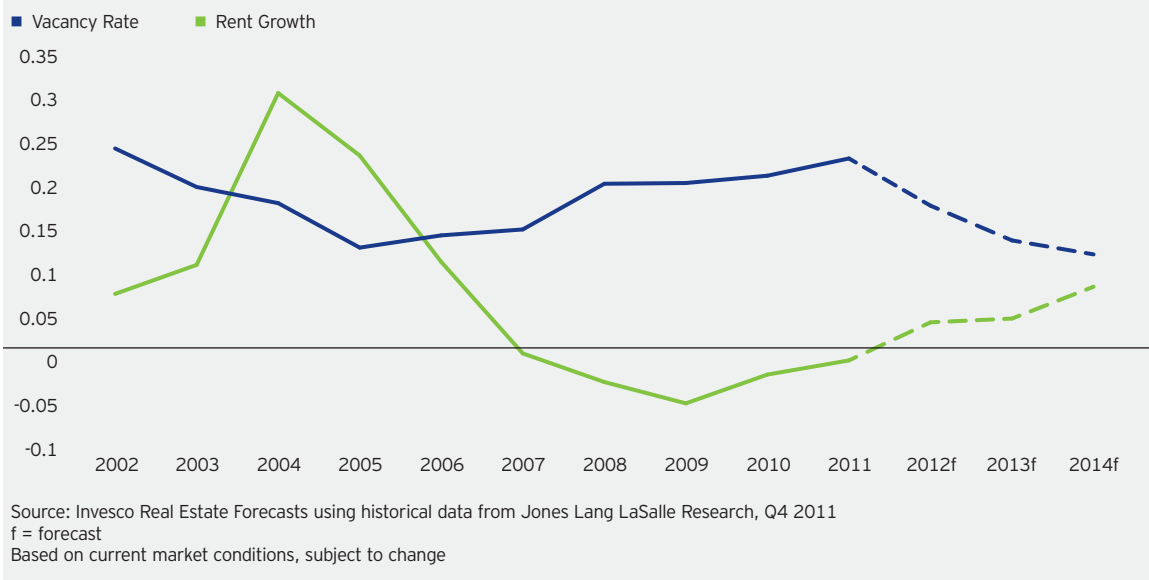
### **Macro Themes: Above-trend rebound with post-flood fiscal stimulus and recovery**

- The catastrophic flooding in October last year left Bangkok at a standstill, claimed more than 600 lives and disrupted global supply chains for the electronics and automobile industries. The World Bank estimates damages of as much as US\$45 billion with Japanese manufacturers also suffering significant losses. The Bank of Thailand further estimated the impact of the flood to be 3.1% of GDP.
- In response, the government announced a slew of measures to stimulate rebuilding activity, assist the flood affected residents and regain investor confidence including: extending loans to SMEs, cutting corporate tax rates, proposing hundreds of flood prevention projects, improving infrastructure, offering loans for renovating houses, providing additional tax deductible allowances and cash rebates for renovation materials. The Bank of Thailand also cut its benchmark policy rate twice by 25 bps each time to 3.0%.
- Following the floods, consumer confidence dropped sharply to its lowest level in 10 years. As rebuilding activity gathers momentum and employment conditions normalize, we expect consumer confidence to improve rapidly. Looking ahead, while GDP registered a 9% q-o-q contraction in Q4 2011, there are signs of a V-shaped recovery in industrial production, private investment, consumption and tourism. Consensus forecasts point to above-trend GDP growth of 4.9% in 2012, barring a significant deterioration in global economic conditions. Inflation is forecast to be moderate and within the Bank of Thailand's core inflation targeted band of 0.5% to 3.0% for monetary policy.

## Real Estate Market Update: Property sectors subdued in the short-term by supply before picking up in 2012 to 2013

- The Bangkok real estate sectors were quiet as adverse conditions slowed office leasing demand, postponed residential projects and restrained retail sales.
- The office sector is currently marked by soft occupier demand and high vacancy. While leasing activity was significantly hampered by the floods with 36 out of 50 districts affected, the CBD was less affected and registered overall positive take-up. Some tenants took the opportunity to upgrade and secure higher quality buildings at lower rents. With no significant net new supply until 2015, the market cycle should gradually recover and we forecast vacancy rates easing from a nine-year high. After rents stagnated in Q4 2011, we expect progressively declining vacancy to support moderate rent growth in the next few years averaging around 5% pa (Figure 35).

**Figure 35 – Limited New Office Supply, Solid Take-Up and Declining Vacancy to Support Rent Growth**



- While retail sales and consumer sentiment experienced a short-term slump, the retail market is underpinned by the longer-term fundamentals of the growing economy, recovering tourism industry and rising middle class. Household consumption should also normalize with improving labor conditions. Mass and luxury retailers such as H&M, Prada, Uniqlo and LV continue to expand and open new stores. Ikea's first outlet in Thailand is its biggest store in Southeast Asia. Rent growth increased marginally in Q4 2011 with prime retail centers located in inner Bangkok unaffected by the flooding. Looking ahead, the retail landscape should be enhanced as major centers complete renovations and new quality malls come on to the market. The majority of new projects this year are located in the inner city area. As a result, strong absorption should support rent growth despite rising vacancy, particularly as the economic recovery takes hold during the year.
- The residential sector remains soft given the ample pipeline of mass market condominiums and subdued consumer confidence. Nevertheless, demand has emerged from residents living outside of Bangkok seeking inner city locations and high rise developments, which may be deemed as safe havens from future floods. Some developers have postponed projects and may incorporate flood prevention systems and enhanced landscaping before selling. According to Jones Lang LaSalle, high-end rents continued to edge down 2.2% in Q4 2011 and 4.4% for the full year. Some landlords also lowered rents for flood-impacted residents. Looking ahead, a large existing inventory and substantial new supply pipeline should continue to exert downward pressure on rents.

- The investment market was quiet in Q4 2011 due to the floods and global uncertainty. Nevertheless, investors remain keen for good assets with steady cash flows. Prime retail assets remain tightly held by owners and no transactions were recorded in Q4 2011. Commercial yields are expected to compress by 15 to 25 bps over the next two years. Despite ample supply, residential yields should hold stable as the market remains supported by government policies to boost the economy and prices are underpinned by local pent-up demand and lower mortgage interest rates. Thai buyers continue to actively seek lower to upper mid-end condominiums, particularly those close to the new or proposed BTS or subway stations for self-use and investment.



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## Contact us

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### **Invesco Real Estate**

41/F, Citibank Tower  
Citibank Plaza  
3 Garden Road  
Central, Hong Kong

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