



Investment Insights

Invesco Real Estate



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Asia Pacific Real Estate

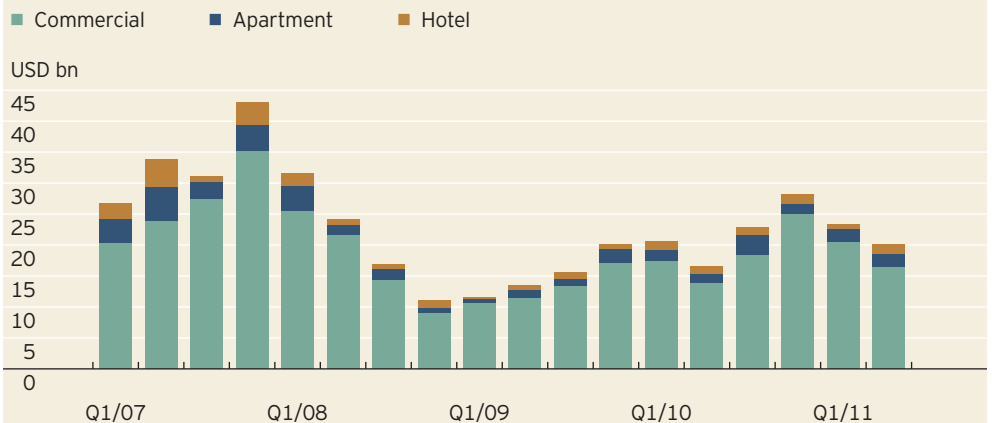
Opportunity Amidst Global Economic Uncertainty

Global economic uncertainty is casting a shadow over the real estate market in the Asia Pacific region. While we believe investment returns will soften, we continue to see opportunities for investors with different investment objectives. Below we will discuss investment strategies for the major markets in the region, and highlight key considerations investors should keep in mind.

Investment activity

Real estate investment activity in Asia has been recovering since the global financial crisis in 2008. According to Real Capital Analytics, total commercial real estate transaction volumes increased by 18% in H1 2011 compared with the same period last year (figure 1). This is despite disruptions in transaction activity in Japan from the earthquake earlier in the year, and government fiscal and monetary policy tightening in China. As of H1 2011, the Asia Pacific region accounted for 22% of the world's total commercial real estate transactions, compared with 10% in H1 2007, reflecting an increasing allocation of capital to this region.

Figure 1 – Commercial Real Estate Transaction Volumes in the Asia Pacific Region



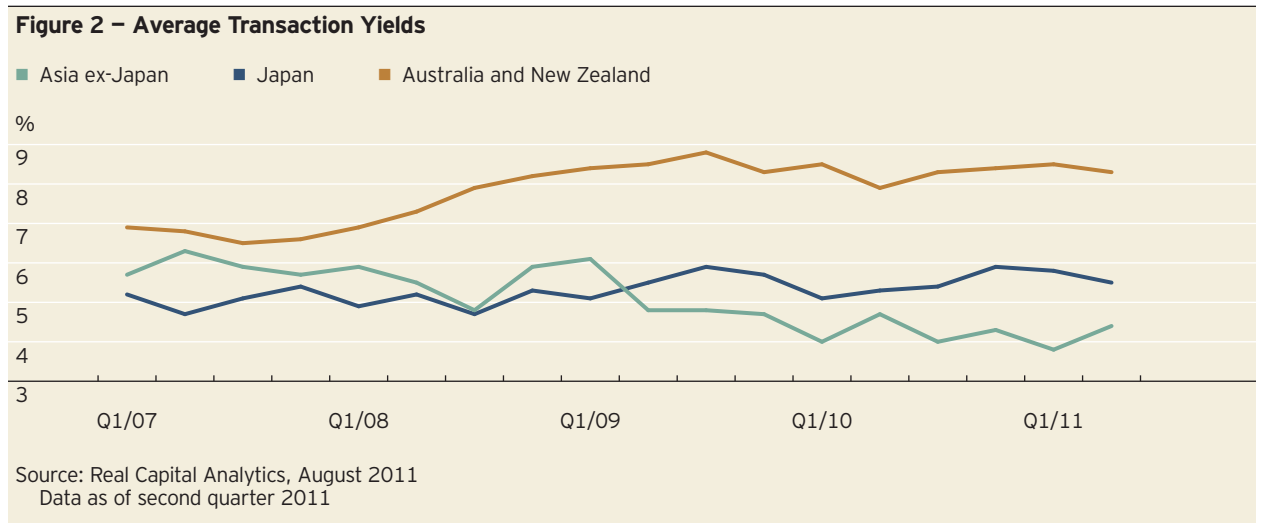
Source: Real Capital Analytics, August 2011
Data as of second quarter 2011

Continued yield seeking to keep prime property yields low

Amidst low interest rates, a strengthening desire for income has driven investment capital into markets offering higher initial yields with positive yield carry. These markets include Hong Kong, Singapore and Australia, where commercial transaction volumes increased by 50%, 90% and 43%, respectively, on a year-on-year (y-o-y) basis in H1 2011. Japan should have fallen into this category but the massive earthquake largely stalled the market in Q2 2011. In H1 2011, total Japanese commercial real estate transaction volumes fell by 17% y-o-y, with a further breakdown revealing an 8% y-o-y increase in Q1 and a 56% y-o-y decline in Q2.

Investor preference for stable income streams and centrally located assets has driven yields for prime properties lower (figure 2). The yield compression trend started in Asia ex-Japan, where these markets have generally been less affected by the global financial crisis due to stronger private and public sector balance sheets. The recent uptick in yields was due primarily to increasing transaction activity in smaller markets, including South Korea and Taiwan. This may reflect that certain investors have started to seek returns by moving up the risk curve. Japan also saw yields compressing in the recent quarters. The expanded monetary loosening measures after the earthquake suggest interest rates will remain low for an extended period. Yields in the Australian and New Zealand markets have also begun to harden.

Generally speaking, we believe the weight of allocated capital is expected to keep yields fairly stable. In most markets, yields are still above borrowing rates while inflation remains high. As we do not anticipate significant increases in interest rates, the opportunity cost for holding and financing properties should remain low. Low holding costs should give owners room to persevere through market turmoil, especially in the Asia ex-Japan markets, where household and corporate indebtedness have been low. These supporting factors are, however, likely to be countered by a weaker economic outlook leading to softer rental growth expectations.



Softer occupier demand coincides with declining new supply

The rental growth outlook remains positive, albeit subdued, in most markets. On the demand side, a dimmer economic outlook suggests occupier demand should soften. Globally, we believe economic growth is moderating. The growth of major Western economies is likely to be anemic over the next one to two years, as they continue to deleverage. This is expected to negatively impact export growth from Asia, a key driver of economic growth in the region.

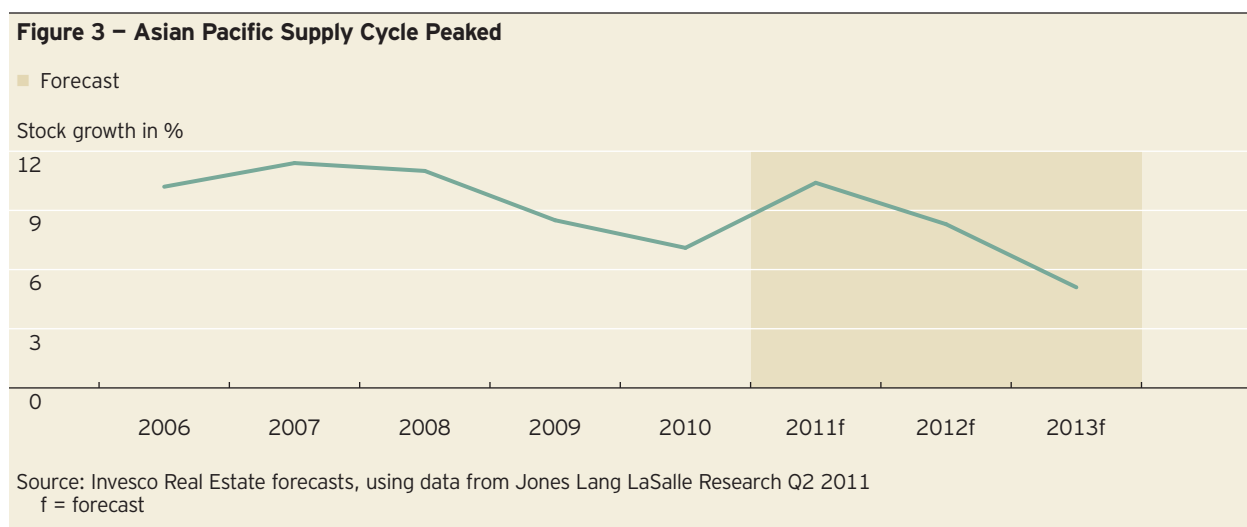
In addition, fragile confidence in global economic growth stemming from the lingering European sovereign debt crisis and weakened confidence in the U.S. economic recovery have led to severe volatility in the capital markets, affecting general investment sentiment in the near term. The negative wealth effect is also expected to put pressure on consumption.

Domestically, credit growth has been moderating across major economies in the region as a result of recent monetary tightening measures, including interest rate rises and lending controls. This is likely to dampen investment growth and headline nominal economic growth rates in general. With consumer prices elevated, governments are unlikely to loosen their monetary policy in the short term. The exception is Japan, where the government expanded its quantitative easing scheme in an attempt to support a post-quake recovery.

In the face of rising uncertainty, some of the largest financial institutions have recently announced global headcount reduction plans and there have also been anecdotal reports about factory closings in China. While we do not expect a significant downturn in employment growth in the region, the less promising outlook is expected to weigh on sentiment.

Nevertheless, we believe that the Asia Pacific region should weather the anticipated economic slowdown better than the Western world, due to the healthier public and private balance sheets in the region and solid consumer demand growth. In the meantime, the downside impact of weakening Western demand could be alleviated by strengthening intra-regional trade as well as trade with other emerging economies. Moreover, commodities prices could be peaking, leaving room for central banks to end the current round of monetary tightening sooner than expected, mitigating the downside risk on economic growth. As such, we expect to see steady, albeit more moderate, occupier demand.

Meanwhile, the weaker outlook on demand is generally coinciding with declining new completions across many market sectors (figure 3). This is especially true for the developed markets such as Australia, Japan and Hong Kong. Although high volumes of new completions are expected in some of the rapidly developing markets such as China, Thailand and Malaysia, buildings in these markets, due to poor property management, could become obsolete more quickly and demand is also expected to be relatively stronger.



In addition, most markets are operating at vacancy rates below their 10-year historic average levels, with a number of them, such as Beijing offices and Hong Kong retail, at their decade low. As such, landlords could remain firm on asking rents. Overall we expect rents to rise but growth rates to moderate (figure 4). Based on the anticipation of stable yields and slower rental growth, we expect the total return of the Asia Pacific real estate market to moderate from 2011 onwards (figure 5), in line with the softening economic growth trend. Over 2011 to 2013, we believe total returns will average approximately 10%, with income return a key component of total returns and rental growth a strong driver of capital growth.

Figure 4 – Rents Rising at Slower Rates

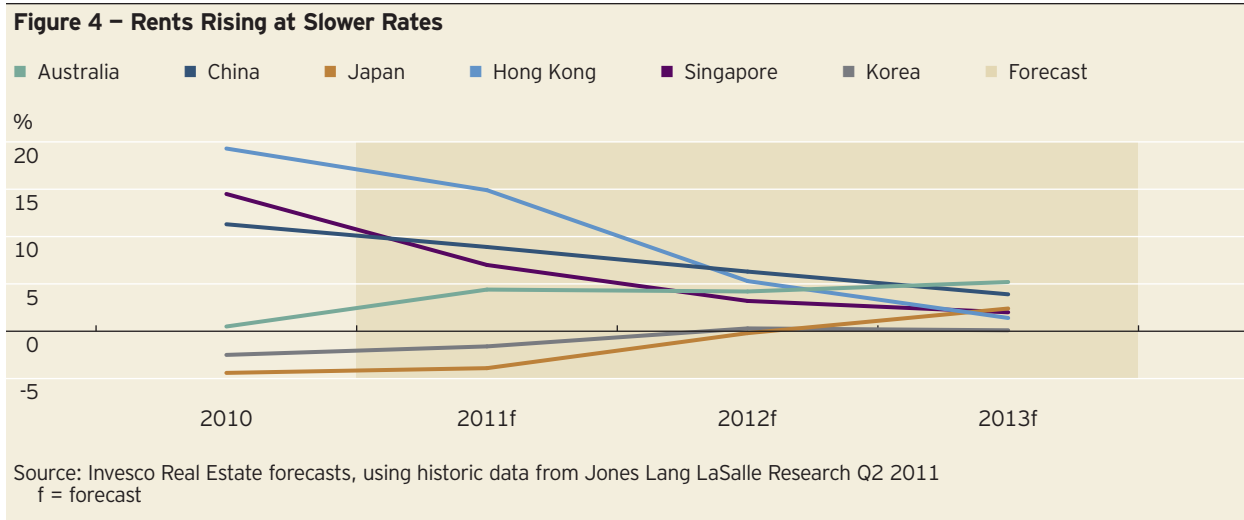
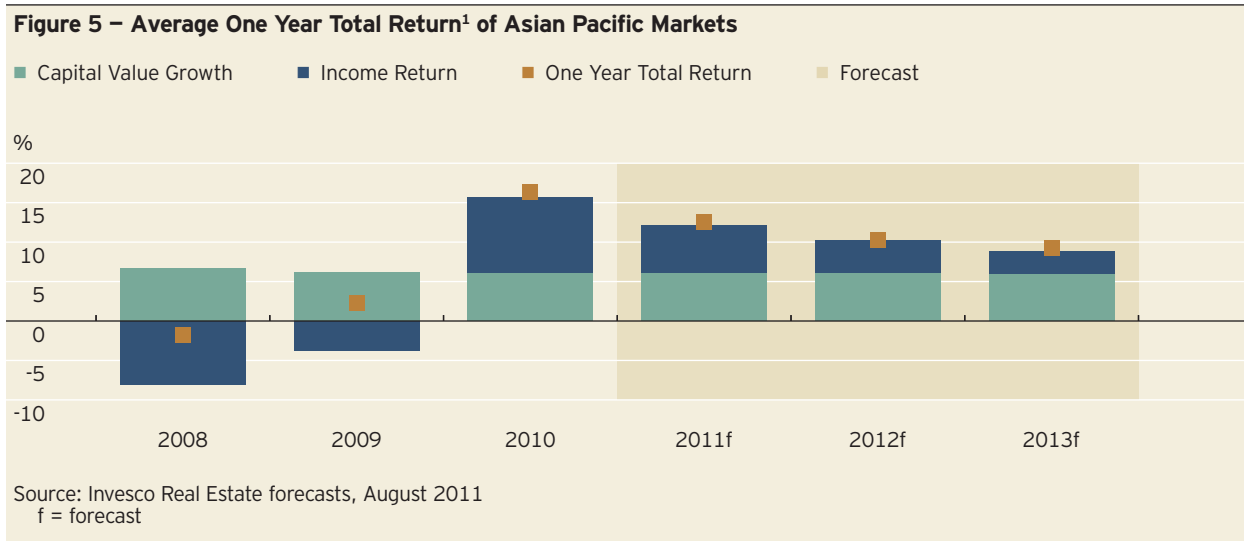


Figure 5 – Average One Year Total Return¹ of Asian Pacific Markets



Commercial sectors expected to outperform

By sector, we expect the retail sector to be a sustainable long-term performer. This is especially true for China, where personal incomes are on a rising trend and the middle class is growing rapidly. Retail assets strategically located near key infrastructure should continue to outperform.

Performance of the office sector depends on supply conditions of individual markets. A number of markets, such as Beijing and Sydney, have passed through their supply peaks with new completions being taken up steadily. Meanwhile, there are some oversupplied markets, such as Osaka and Seoul, where any investment needs to be assessed more cautiously.

Regulatory risks remain the key concern in the residential sectors, as local governments continue to ensure affordability. This is becoming more of a political topic rather than an economic consideration. With elections coming up in Korea and Hong Kong, and the change of government in China in 2012, housing affordability is likely to continue being scrutinized by political parties. In Singapore, after the recent election, the new government has been very firm on increasing housing supply. The exception is Tokyo where there are minimal policy risks and yields are high.

¹ Unlevered, gross return before taxes, transaction costs, CAPEX and depreciation

Opportunities for core and value-add strategies

Stemming from the uncertain global economic climate, there are clear risks. For example, a sharper-than-expected global economic downturn could crimp occupier demand. In the meantime, the lingering European debt problems and fragile confidence could intensify volatility in the capital markets. The solvency of certain commercial banks could be affected with ripple effects on the global financial system and liquidity. Borrowing costs could rise and the availability of loans could decline should the situation worsen. Any parties involved in investment underwriting should also be mindful of overleverage.

However, despite the economic uncertainty, we believe that the Asia Pacific real estate market continues to offer potential opportunities:

- **Markets continue to offer high initial yield and positive carry.** As a result of the strengthening desire for income, we believe core assets with stabilized income may be sought after. The Japanese and Australian markets are well positioned to capitalize on this trend. Both markets offer higher initial yields relative to the rest of the region, appealing to income-oriented investors. The average lending terms in Japan allow a decent 250 to 350 basis points positive carry. Australian banks are also becoming more accommodative and have recently lowered the loan spread for non-recourse lending and, as a result, positive carry is reemerging, even for prime properties in Sydney.
- **Tight supply creates opportunity for value-add investing.** Where there are strong interests for core, prime properties are usually tightly held and well bid. In light of generally declining new completions and current low vacancy, opportunities for development or redevelopment are available. Curing underperforming assets of problems via refurbishment, re-tenanting or repositioning, or change of use to improve rental income is feasible in markets where new supply is expected to be limited or solid rental growth is expected, such as within the office and retail sectors of selected Chinese cities, Hong Kong and Singapore.
- **Capitalize on weak sellers.** Overall, distressed opportunities should be minimal given the generally healthy balance sheets of the private sector. Even if they arise, competition is usually fierce. Nevertheless, in markets where financing of development projects is more restricted, such as in Korea and Australia, there are developers/construction companies in need of capital to complete their projects. Similar opportunities could arise in China from smaller developers/landlords due to the government's strict controls on lending. In Japan, investors could take the opportunity to purchase distressed assets from banks. Asking prices for these assets could present a discount to market prices. These opportunities are normally not widely marketed and on-the-ground local knowledge is vital to accessing them.

In light of the current environment, we believe the focus should be on protecting income from any real estate investments by maintaining and improving occupancy via proactive negotiation in pre-leasing or rent reviews/renewals.

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