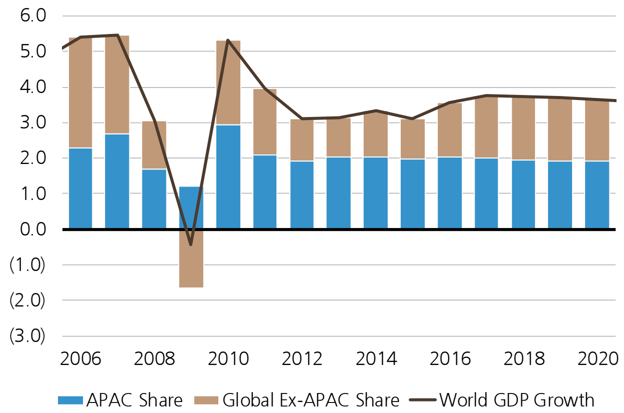
Asia Pacific Quarterly Update – 3Q15

Near-term caution, medium-term opportunities

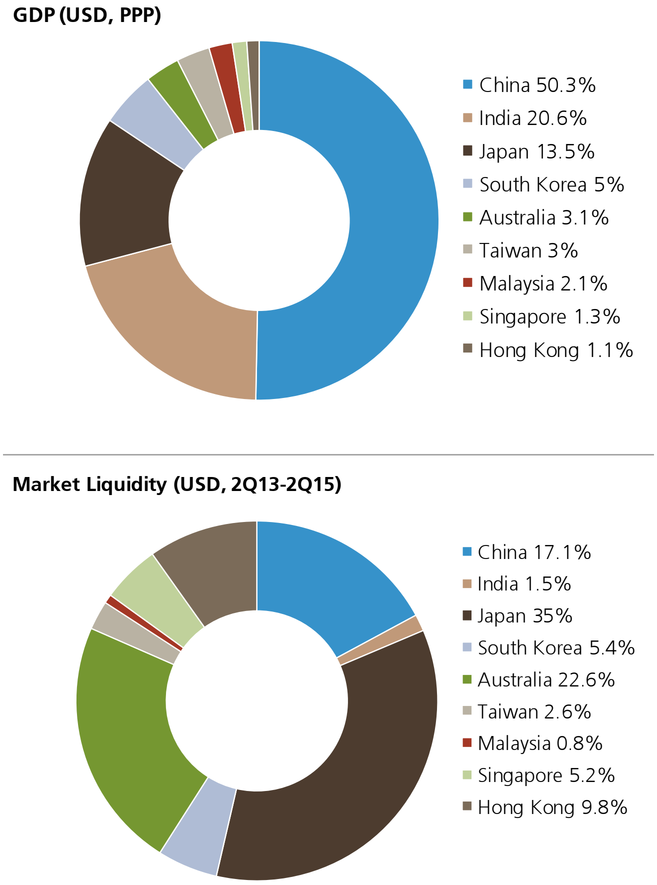
Macro outlook
The near-term outlook for the Asia Pacific (APAC) region is set to remain sluggish over the next 12-18 months as China gradually moves towards a sustainable growth model, global trade remains lackluster and weaker credit growth hits domestic demand. The positive impact of lower commodity and energy prices on profits and incomes, and accompanying monetary easing, will continue to be offset by the corporate and household sectors' need to reduce debt levels which will weigh on near-term growth prospects. We expect, however, that further monetary easing via lower interest rates and weaker currencies and increased infrastructure spending should minimize the downside risks for the region.

Chart 1a: APAC growth as share of global GDP growth



Source: Oxford Economics, as at 14 September 2015

Chart 1b: APAC market splits, by GDP and market liquidity



Source: Oxford Economics, RCA, as at June 15

In the absence of a sharp pickup in demand from Europe and the US or renewed pickup in regional leverage, APAC growth is set to average around 5.1% p.a. over the next five years compared to 6.4% p.a. over the previous decade. Despite the tougher macro environment, the region is still expected to contribute more than 50.0% to annual global GDP growth over the next three to five years (measured in Purchasing Power Parity terms), providing significant opportunities for capital targeting the region. Further out, structural reforms – particularly in the services sectors across the region – should help to restore the region's growth premium supported by improvements in productivity. In turn, this should re-establish the outperformance of investments in the region.

Rebalancing China's economy
In the aftermath of the financial crisis, China's policymakers unleashed a significant amount of monetary and fiscal stimulus in 2008 to support headline growth and counteract deflationary forces emanating from the US and Europe. Much of this additional stimulus found its way into higher levels of public infrastructure investment and increased capacity of the industrial and real estate sectors. This was largely achieved through a sharp increase in the leverage of its local governments, state owned banks and enterprises, and real estate developers. China's global shock absorbing capacity was further reinforced by strong wage growth, the appreciation of the Chinese Yuan (CNY), and accompanying loss of competitiveness relative to developed markets, which helped to offset weak global demand.

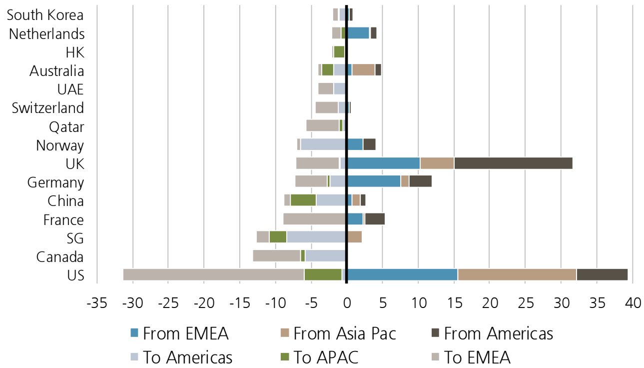
In effect, China's stimulus helped to pull the global economy out of a tailspin in 2009. The payback period, however, is now curbing domestic and regional growth relative to developed markets. The knock-on impact of slower growth is hitting China's regional trading partners – including Hong Kong, Taiwan, South Korea and Japan, commodity exporting countries (e.g. Australia, Indonesia and Malaysia) and emerging markets in general – through lower commodity prices or lower growth in key commodity exporting countries. Elevated credit growth and declining marginal returns on investment are forcing policymakers to turn to other drivers to support growth. As such, reforms are gradually being implemented to move the economy from debt (and savings – the flipside of debt if these savings are deposited in a bank that lends out the capital), investment and industrial production towards consumer spending and services sector employment. Already this transition is taking place.

Ultimately, these reforms should ensure China and the broader region's growth model will be more sustainable with lower savings rates and better paid services jobs supporting robust consumer spending. The transition has been (and will continue to be) far from smooth, however, with growth slowing, volatility returning to regional and global financial markets and currencies under pressure. Although investors should expect slower economic growth over the coming years these reforms should prove positive for the quality of domestic jobs and employment growth in China. In turn, the broader outlook for the APAC region is likely to prove more resilient and sustainable over the medium term.

In the unlikely event of a major unwinding of corporate and local government debt triggering contagion in China's wider financial sector – via increased borrowing costs, asset re-pricing and pullback in bank credit – we believe that policymakers have some ammunition to minimize the fallout for the real economy. Financial conditions have already tightened across the region in recent months in an environment of lower growth projections and weaker currencies with increased risk aversion pushing up borrowing costs for investors. With core inflation remaining contained, real lending rates elevated and government debt levels relatively low compared with European and US counterparts, there is still room for monetary and fiscal policy to be eased. We believe these easing measures will help to minimize the likelihood of a sharper slowdown scenario in the case of widespread financial contagion. Conversely, investors should not expect that policymakers will use these policy levers to stimulate growth from current levels with central banks quickly discovering the +limits of monetary easing.

APAC commercial real estate
In the commercial real estate sector, transactional activity remains focused on the region's developed markets with Japan and Australia representing in excess of 60.0% of transactions over the past 12 months in USD according to data from RCA. The figure would be higher in local currency given the 8.8% decline in the Japanese Yen (JPY) and 19.9% decline in the Australian Dollar (AUD) against the USD over the past 12 months to 3Q15. Further capital outflows from the region's emerging markets are likely in the near term as investors further diversify their portfolios and reassess near-term return expectations in an environment of slower macro growth and easing credit cycle. This should provide further support for the cyclical recovery of pricing and liquidity for the recipients of these capital inflows.

Chart 2: Global capital flows, by market
(USD billions, positive values represent capital inflows and negative values refer to capital inflows)



Source: RCA, as at June 15

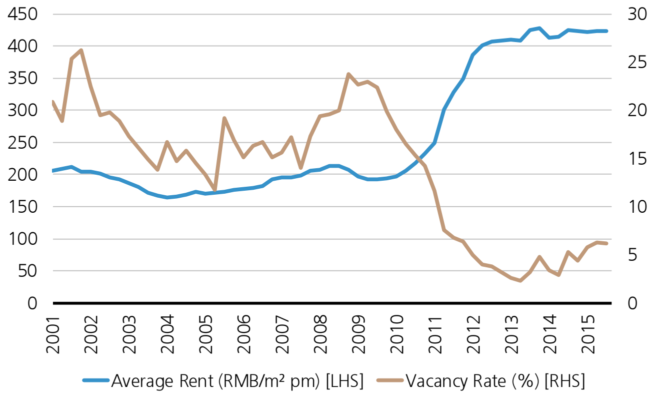
Over the medium-to-longer term, higher gross value-add and employment in the services sector will provide strong support for the region's emerging markets including China, particularly in the office and retail space, once the excess capacity is absorbed or converted into an alternative use. This should ensure the region's emerging commercial real estate market outperform over the longer run.

China
China's real estate market continues to be dogged by oversupply concerns in the near term, as resultant effects from years of overbuilding take a toll on market confidence. A weaker economic backdrop further exacerbates the existing cautious mood among investors, who have gradually adopted a more selective attitude in their investment approach.
On the policy front, the central government has been pushing ahead with monetary and fiscal stimulus measures to stabilize growth, while focusing on the

implementation of structural reforms. We hold the view that short-term economic aberrations are inevitable, but this fundamental transformation in China's social and industrial structure will bode well for a sustainable property market. Tier-one[1] cities such as Shanghai and Beijing continue to look interesting to investors seeking core allocation and exposure into China. These cities offer substantial economic depth and resilience, and are expected to be the frontline beneficiaries of any pickup in economic growth. Lower tier cities, which generally saw a sharp run up in asset prices in the post-crisis environment, are likely to suffer from chronic cyclical pressures as investment and development sentiments remain soft in the next few years.

In the office investment market, both domestic and foreign capital continue to jostle for institutional grade assets in tier one cities, and core office buildings in Shanghai remain highly sought after. The lack of investable grade assets in China is a key reason why prime office yields in Shanghai and Beijing held steady at 4.50% and 4.75%, respectively this quarter, with capital values rising in tandem with prime rents. In the lower tiered cities, construction of multiple CBDs in recent years has resulted in an overbuilt environment, which is hardly aligned with the density of business activities required to support office absorption in the short term. In Shanghai and Beijing, however, increased leasing activities from domestic firms will continue to support rental growth in core CBD areas despite sluggish demand from multinational firms. In Shanghai, domestic financial services companies continue to pursue limited office space in Pudong, providing upward support for prime office rents. Beijing has not experienced a strong inverse relationship between office vacancy and rents, as leasing demand for quality grade office is underpinned by the expansion of technology companies and domestic firms.

Chart 3: Beijing Office - Rent and Vacancy



Source: CBRE, as at September 2015

On the retail front, yield decompression is to be expected in the next few years, as a deluge of decentralized retail space is completed across major cities in China. In Shanghai and Beijing, however, we project prime retail rents to still edge up in the next 12 months, albeit at a slower rate of 5.0%. Robust income growth and high propensity to consume in major cities will cushion the resilient leasing demand for core retail space despite the surge in decentralized retail space. Demand from luxury retailers will remain muted, as they turn cautious on expansion plans due to the ongoing austerity and anti-corruption drive. In turn, fast fashion and mid-high end retailers are expected to lead leasing activities in gateway cities, riding on the consumption aspirations of the middle income segment. Differentiated performances among retail sub-markets and assets is likely to become a key theme and mall operations become increasingly critical in the face of e-commerce retailing and the supply overhang. This means that multi-speed investment and leasing markets will surface, with well-located and stabilized retail assets commanding huge capital value and rent premiums over their lesser counterparts.

The short-term prospects for residential property in China continue to be dragged down by indigestion concerns, particularly in the lower tiered cities. To that end, the central and local governments have gradually relaxed restrictions on home purchases and loans in a bid to prop up residential demand. In the first half of 2015, residential sales volumes in tier-one and two cities reported their first positive year-on-year growths since 2013 and this theme has continued into the third quarter. We believe that home prices and sales volumes in tier-one cities are expected to turn the corner first with the renewed return of investment interest. On a related note, the ongoing e-commerce boom is also

[1] Tier one cities in China refer to Beijing, Guangzhou, Shenzhen and Shanghai

generating a healthy appetite for quality grade industrial assets. Despite slower GDP growth prospects in China, we expect the modern logistics space to continue its structural expansion in the coming years on the back of e-commerce growth, rising outsourcing and expansion of organized chain retail. The next battlefields and opportunities are likely to be in secondary inland logistics hubs where entry pricing remains relatively competitive.

Capital inflows slowed on the back of further pull-back in liquidity conditions and widespread worries over China's macroeconomic outlook. The start of the Fed rate hiking cycle and the recent devaluation in CNY may aggravate near-term capital market conditions, and foreign capital has already started to adopt a more guarded approach in light of any further potential devaluation of the CNY. Onshore debt availability remains tight as deleveraging efforts ramp up, and looks set to be further squeezed, as corporate demand for onshore financing increases indirectly as a result of the CNY devaluation's impact on offshore financing costs.

As economic restructuring gathers momentum, we are longer-term positive on selected gateway cities in China with buoyant local economies and strong educational resources, which will be vital in riding the services growth wave. In the near term, however, we are of the view that core commercial property markets in Shanghai and Beijing are likely to outperform other markets in China in the next two years, mainly on a risk-adjusted tactical basis, given that asset pricings across the board have not really normalized in tandem with the softer economic landscape.

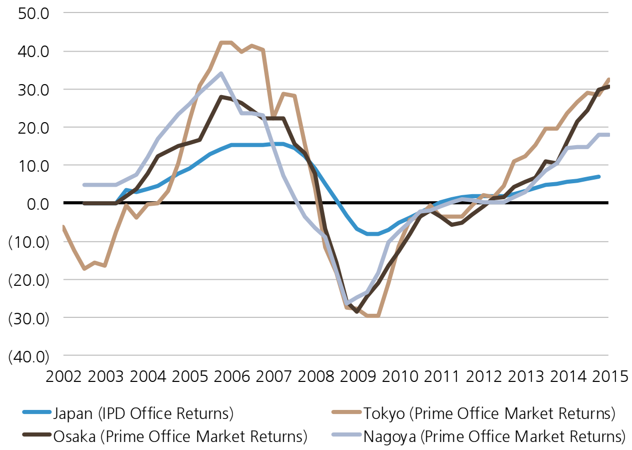
Japan

Japan's post-crisis economic recovery remains patchy and prone to shocks with the GDP contracting by 0.30% in 2Q15. The pullback was driven by quarterly falls in consumer spending, business investment and exports. The recent underperformance of the external sector reflects weaker demand from emerging Asia, particularly for capital goods given the gradual rebalancing towards consumer spending taking place in China.

Under our base case, we expect that Japan's tightening labor market will gradually translate into higher wage growth and accompanying pickup in core inflation and consumer spending over the medium term. In turn, this should support business investment in the services and non-tradable sectors, which should help to offset soft capital spending in exporting sector. Near-term risks, however, remain skewed to the downside given ongoing weakness of demand from key trading partners and renewed financial market turbulence may hit asset pricing and investor sentiment. Capital spending and exports would be hit under this scenario as the JPY appreciates during a period of reduced global risk appetite.

Despite the patchy macro environment, the Bank of Japan's quantitative and qualitative easing program and relatively healthy credit growth have supported elevated levels of investment activity and capital appreciation in the commercial real estate sector. Overall, transactions are now back to 2007 levels with Japan's listed real estate investors particularly active given the sharp improvement of their balance sheets in recent years.

Chart 4: Investment Performance (local currency, % p.a., unleveraged)



Source: IPD, PMA, as at June 15

On the back of elevated levels of investment demand, pricing has seen a sharp recovery over the past 24 months with prime yields in Tokyo's central five wards[1] moving below 3.0% this quarter compared to 4.0% a year earlier and a low of 3.5% in 2Q07. Similar yield compression has been seen in other sectors with yields now tracking below pre-crisis levels for both prime logistics and retail assets. Focusing at absolute pricing, prime office capital values per square meter (psm) remain 20.0% below 2007 levels as rents have yet to fully recover previous peaks. On this basis, there is still some upside to core investments over the next 12 months, particularly if further monetary easing is required to support the broader economy. Beyond the near term, however, capital appreciation is expected to

[1] Central five wards (C5W) in Tokyo refers to Chiyoda, Minato, Chuo, Shibuya and Shinjuku

grind to a halt in the prime space as yield spreads fall below historical averages and investors continue to include higher yielding assets and strategies in their portfolios which offer better upside potential.
In terms of fundamentals, occupier demand has been supported by the sharper decline in prime occupancy costs relative to secondary rents in the aftermath of the collapse in demand as result of the financial crisis. Overall, prime effective rents fell around 45.0% from peak to trough compared with a 25.0% decline for secondary locations thereby providing corporates with a strong incentive to relocate ahead of any occupier market recovery. Subsequently, prime rents have increased by 15.0-20.0% from their post-crisis lows. Robust earnings for large corporates and relatively healthy jobs growth have also supported the recovery in rents and occupancy levels, particularly in Tokyo's CBD market. Across the central five wards, vacancy rates have fallen to just under 5.0% this quarter compared from around 7.5% a year earlier, which has supported rental growth of in excess of 5.0% over the past 12 months.

Looking ahead, the key challenge for new capital is the ability to source quality assets given the intense competition from domestic investors in Tokyo's CBD. As a result, investors are looking beyond the Tokyo market for broader exposure. Given the recovery in fundamentals, we expect that value add opportunities will outperform over the near-to-medium term. Niche strategies such as hotels, luxury retail and multifamily residential apartments should be supported by the lower currency, rising tourism numbers from China's middle class and the buildup to the 2020 Olympics.

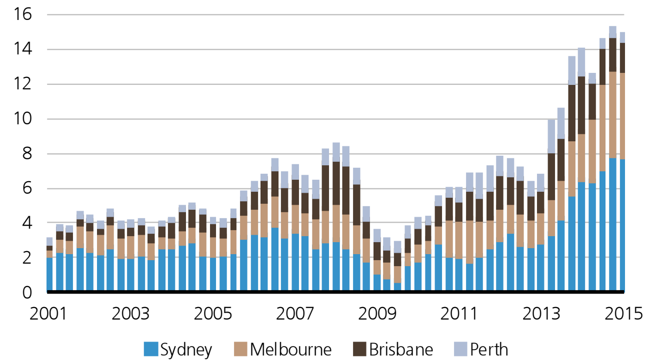
Australia
Australia's labor market has held up relatively well in recent quarters despite subpar growth and ongoing retrenchment of jobs in the mining sector. This is reflected in a relatively stable unemployment rate alongside healthy jobs growth and hours worked over the past year. Structural and cyclical factors appear to be at play. To some extent, the mining sector's contraction is being offset by a cyclical pickup of construction jobs, particularly in the residential sector as lower interest rates supports rising housing activity. In other sectors, rising demand from China's middle class and a lower currency can be expected to support jobs growth in the tourism, education and consumer services over the medium term. More pessimistically though, labor market resilience also reflects the increasing number of lower paid retail jobs and sluggish wage growth as firms substitute relatively expensive capital for cheaper labor. With policymakers no longer able to rely on strong credit growth and elevated commodity prices to support growth, structural reforms will need to be implemented to reverse the slowdown in productivity and wages. Although this slowdown is hardly unique to Australia – it is a problem facing many developed markets including the UK and US – it has only become more apparent in the wake of the sharp decline in commodity prices and accompanying hit to corporate earnings, government revenues and household incomes.

In an environment of below trend growth, cities and markets with higher exposure to business services, information, communications and technology sectors and consumer services – such as Sydney and Melbourne – and regional cities with strong links to tourism, aged care and foreign student numbers should prove resilient over the near to medium term. Employment numbers are expected to remain soft in markets that are more exposed to the resources and energy sectors, such as Brisbane and Perth.

In terms of real estate fundamentals, prime rents and vacancies have remained resilient in the CBD office markets of Sydney and Melbourne and, to a lesser extent, Brisbane although effective rents for the best assets have moved sideways for the past two years compared to growth of just under 4.0% p.a. over the past 15 years. With the exception of Sydney, effective rents in secondary and suburban locations remain under pressure given the corporates are reluctant to invest and expand with domestic and external demand remaining sluggish. In the retail sector, rental growth remains largely concentrated in the prime CBD markets on the back of strong demand for space from international occupiers and limited supply. Rental growth in the industrial sector is broadly limited to Sydney and strong in-fill logistics assets in the rest of Australia.

Despite sluggish occupier market conditions, the investment market has remained strong in recent quarters. Year-to-date (YTD) volumes are running broadly in line with 2014 levels with transactions totaling AUD 19.3 billion over the past six months which is 23.0% higher than the same six-month period in 2014. Although core yields are closing in on pre-crisis levels, foreign investors continue to be attracted to Australia's relatively attractive income returns and financial stability in the region. Lower local interest rates – which ensures property spreads remain attractive compared with other yielding asset classes – continues to support strong inflows from domestic investors.

Chart 5: Office transactions, by market (AUD billions)



Source: CBRE, as at March 2015

The majority of this domestic and international capital remains focused on Sydney and Melbourne where stronger occupier demand dynamics are supported by jobs growth. Reflecting the lower yield environment, IPD reports that All Property total returns at the asset level (pre-fees and leverage) have accelerated to 11.3% on a 12-month rolling basis from 10.8% in the previous quarter.

Looking ahead, investment performance is expected to remain relatively healthy over the next 6-12 months particularly in a sluggish growth environment where the yield curve is likely to flatten. Industrial assets in strong locations and better quality office assets in peripheral CBD sub-markets are expected to outperform in the near term. Niche strategies such as student accommodation and hotels in Sydney and Melbourne will also see healthy performance as fundamentals improve further given rising demand from foreign tourists and students. We remain cautious on exposure to secondary retail locations, and the Brisbane and Perth markets in general, although counter-cyclical opportunities will become available as pricing becomes more attractive.

South Korea

The economy grew by just 0.3% last quarter, the weakest expansion in the last six years. Temporary factors such as the Middle East respiratory (MERS) virus outbreak caused household spending to fall by 0.3% after three reasonable quarters of growth. In addition, the sharp weakness in demand from China has seen Korea's export growth slow sharply over the year. To that end, the Bank of Korea cut its benchmark policy rate by 25 basis points to 1.5% in June, representing an unprecedented low and the fourth such lending rate cut since August 2014. To further support business sentiment and consumer confidence, a stimulus package was also announced almost immediately on the back of the rate cut.

Household spending is expected to pick up by the end of the year as the impact of MERS fades. There are also signs that the external background may be stabilizing but the recovery in regional trade is likely to be gradual and exports are unlikely to contribute to GDP growth significantly over the next 12 months. Overall, the economy is expected to expand by 2.4% in 2015 before seeing a pick up to 3.2% in 2016 as world trade improves. This compares to average growth of 3.7% p.a. in the decade to 2014.

In the investment market, transactions bounced back somewhat with USD 1.5 billion of transactions taking place over the quarter compared to USD 300 million a year earlier. Year-to-date volumes, however, are tracking lower than previous years with overall investment at 40.0% lower than the same period in 2014. Despite a muted investment activity, core CBD office yields compressed further this quarter which helped to push prime capital values higher by approximately 6.2% over the past year. Prime yields look to harden further in the near term but the rate of compression is likely to slow as investors become more cautious about exposure to slowing economies.

Office leasing dynamics remained sluggish with corporates reluctant to take on expansionary space in an environment of below trend macro growth and elevated supply. The average vacancy rate of Seoul's CBD office market increased to 9.5% in 3Q15, from 9.3% in 3Q14. Net absorption was weak at just under 2.0% of stock p.a. compared to a historical average of 4.0% p.a. Overall office rents are expected to come under pressure given the direct competition from new business districts that offer attractive tenant incentive packages on top of low lease rates. Recent completions of several large Grade A offices have provided more options to occupiers, further tilting the balance of power in favor of tenants. Effective rental growth is likely to be flat over the next 12 months.

As there is still significant domestic and foreign capital chasing after too few transactions, it is likely that yields will compress further in the Seoul office sector. At the moment, we do not see the Seoul office pricing attractive enough to justify any core investment theme, especially as the softness in the occupier market further erodes total investment returns in the next 12 months.

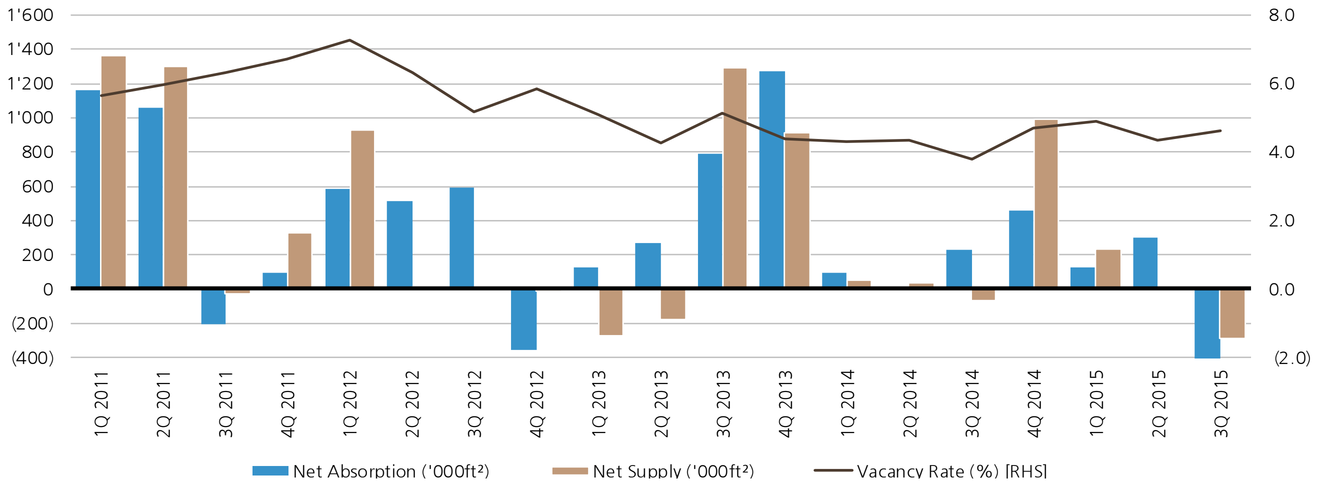
Singapore

Third quarter GDP growth came in at 1.4%, narrowly avoiding a technical recession. In addition to a soft export outlook, growth prospects in Singapore are hampered by the ongoing correction in the housing market. Residential investment is set to remain weak as government policies dampen home prices and slow down new construction. Notwithstanding, government infrastructure spending is increasing; and real wage growth remains solid which will continue to support healthy household spending. As global sentiments improve, world trade flows are likely pick up momentum in 2016, which should provide near-term support to the economy.

The Singapore office leasing market appears to have reached a tipping point in 2015. Prime rents continued to decline by 6.5% relative to the same quarter in 2014, although Grade A office occupancy rates continued to improve. Amid the weak economic backdrop, contrasting forces are at play; ongoing flight to quality is supporting net absorption for prime office space in the CBD, but cost conscious occupiers are at the same time exerting downward pressure on overall rents. Prime demand remains steady, although landlords now appear to be willing to substitute rental growth for occupancy. We estimate a supply influx of approximately four million square feet in 2016 which, to put into perspective, is easily five times the total absorption of the Singapore office space in 2014. This wave of supply in 2016 and the increasing shadow space will continue to depress office rents in the next two years. In the investment market, only six transactions above USD 10 million were recorded in this quarter and total transacted volume declined almost 50.0% from the same quarter one year ago. Given where the leasing market is at this point, we expect investment volume to remain muted and slight widening of yields is likely going forward.
Leasing demand remained soft in the retail sector as weaker tourist arrivals and the labor crunch – on the back of tighter immigration numbers and rising staff costs – take a toll on retailers' expansion plans. Prime retail rents maintained a gradual decline for the consecutive third quarter while suburban retail rents stayed flat, supported by heightened leasing interest in new suburban malls. Given Singapore's transport connectivity and built up urban environment, the traditional differentiation between a prime retail mall and a suburban mall is getting blurred, and rental gaps have fact closed up in recent years. On balance, we expect retail leasing to remains a tenant's market in the next two years as the market readjusts to new supply-demand dynamics. Investment transactions, taking a lead from the leasing market, were anemic. On record, there were only two notable transactions (above USD 10 million) completed in 3Q15.

In the industrial sector, rents for manufacturing facilities have declined by 3.0% on a quarterly basis due to Singapore's lackluster manufacturing environment which is affecting overall occupier sentiment and demand. Looking ahead, near term supply coming on-stream will be almost at a historical high, and is expected to further push down industrial rents. Notwithstanding, investment interest stayed the course in 2015 even as overall transaction volumes (for transactions above USD 10 million) fell by almost 70.0% from a year ago. At yields around 5.0%, we

Chart 6: Singapore Office – Supply and Vacancy



Source: CBRE, as at September 2015

continue to find industrial space in Singapore appealing even as the physical market softens. We believe that policy restrictions on availing land for industrial development will bode well for overall industrial sector health in the longer term, as demand and supply gradually normalizes.

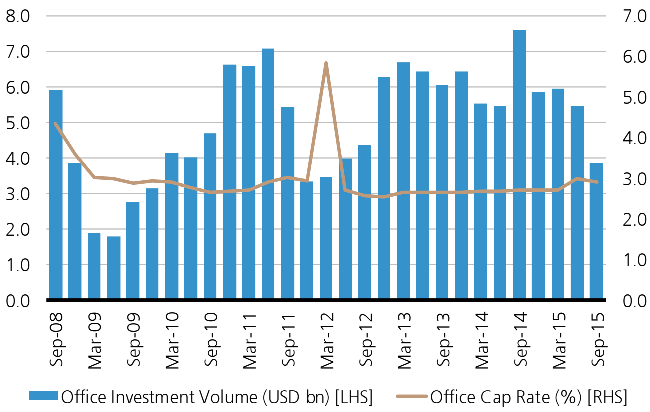
We would exercise caution in our tactical allocation on the Singapore real estate market in the next 6 to 12 months. In general, investment decisions in Singapore are being deferred in light of the impending supply influx in the office, retail and industrial sectors, coupled with elevated pricing and compressed yields. Overall, the investment market is expected to remain subdued in the next year as the expectations mismatch between buyers and sellers continue to limit transactions and volume. Looking ahead, however, we believe foreign capital will continue to be interested in the Singapore market given Singapore fundamental economic strength amid a turbulent global backdrop.

Hong Kong

Tight linkages to the mainland China economy meant that Hong Kong's trade, retail and financial sectors have been hit particularly hard by China's slowing growth and crackdown on corruption. The impending hike in US interest rates may affect highly leveraged households, especially as the residential market continues to look stretched relative to incomes and rents. Tourism spending and arrivals are also being dampened by travel restrictions on visitors from China. Notwithstanding, labour market conditions have been sanguine in 2015, with the unemployment rate hovering at 3.2%; gains in home prices are also providing ample wealth effect and support for private consumption.

In 2015, the Hong Kong office sector experienced a positive boost from recent financial developments in China, in particular the maturing of the Stock Connect Scheme and the Mainland-HK Mutual Recognition of Funds agreement. At the leasing end, office vacancy in the prime Central Office district fell to a seven year low of 1.0% in the third quarter as Chinese financial institutions expanded their presence to take advantage of the deeper pool of financial product offerings in Hong Kong. As the main connection gateway between China and global capital markets, Hong Kong's prime office market is well positioned to benefit from China's ongoing financial liberalization. The next office supply peak will come only in 2017, creating a two-year window for prime office rents to ride this upcycle. In the investment market, a consistent theme remains the shortage of quality assets made available for sale, which is evident in the low number of transactions recorded. Total transacted volumes (transactions above USD 10 million) in the office investment market fell by more than 49.0% year on year in 3Q15. Capitalization rates were slightly compressed at 2.9%, compared to 3.0% in the last quarter, even as prime office rents saw a year to date growth of more than 12.0% in 3Q15.

Chart 7: Hong Kong Office – Investment Volume and Cap Rates



Source: RCA, as at September 2015

On the retail front, overall leasing demand remains subdued and all major districts in Hong Kong are reporting limited leasing activity this year. Luxury brands are now very conservative on tenancy renewals in the prime areas of Central and Causeway Bay, as mainland China's inward tourist arrivals and spending continue to be soft. While Hong Kong does not face a situation of severe retail space oversupply, we are of the view that demand side dynamics will drive downward corrections in retail rents across the board, especially in the prime retail segment. Overall retail rents have already declined sharply by more than 15.0% from a year ago, and we believe another 5.0% drop by the end of the year is not improbable. Investment transactions in retail were muted in this quarter arising from the weak sentiments around the occupier market and the reluctance of vendors to transact at higher capitalization rates. Nonetheless, we expect that strong domestic consumption and a solid jobs market will continue to support local retail spending, especially in suburban retail, as the slowdown in luxury spending by China mainland tourists continues to cast a long shadow over prime retail prospects.

As the external trade outlook for Hong Kong weakens alongside soft retail sales growth, the consequent declining demand from chain retailers and 3PL operators have led to lethargic leasing momentum for industrial space. Warehouse vacancy rates in 3Q15 inched up by two percentage points to 2.6% up from a year ago, even as average transacted rents increased by 3.2% over the same period. Domestic end users remain the main demand drivers in the investment market, with just six transactions above USD 10 million recorded in 3Q15. Hong Kong's status as a leading logistics hub is not guaranteed in the face of competing ports within Greater China, but we believe its role as a key transshipment node will not diminish due to China's restrictive cabotage regulations. To that end, we remain neutral on the prospects and performance of industrial space in Hong Kong, as supply side dynamics should ensure the healthy absorption of modern logistics space.

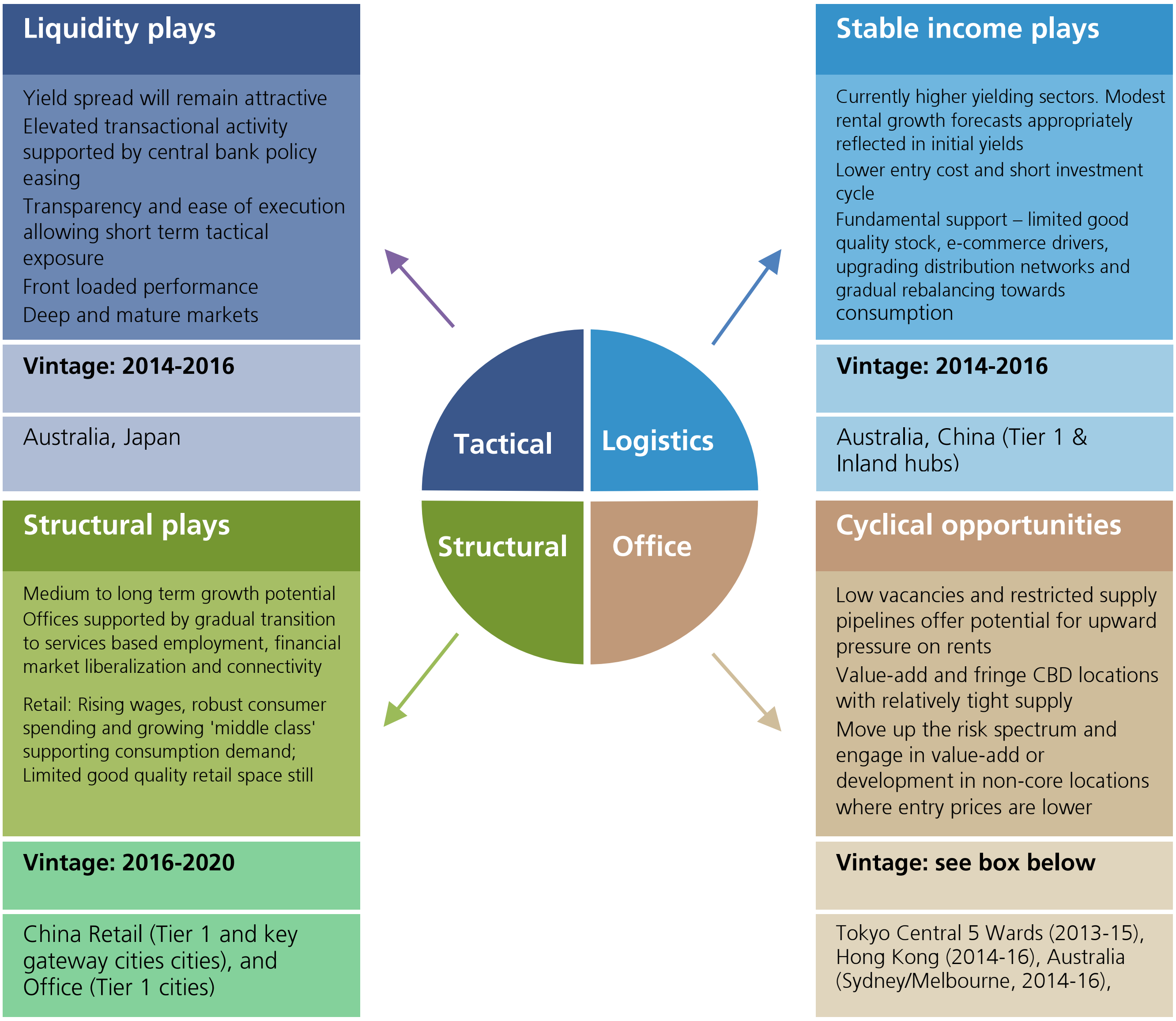
Strategic views

Across the APAC universe, we do not generalize any real estate trends or attempt to extrapolate regional investment themes, given the heterogeneity of markets and cycles. As we formulate our research views, we continue to be guided by our top-down understanding of macroeconomic fundamentals, which is complemented by a keen bottom-up appreciation of cyclical and structural developments in individual real estate markets and sectors.

Our key views are:

– There is a capital flight to quality (and safety) within and out of the APAC region. Liquidity in emerging markets in the region continues to be hampered by financial and economic woes in China, against the turbulent global economic backdrop. But lower oil prices and accommodative monetary policies are expected to shore up economic activity in most APAC economies. Concerns over pricing and the availability of credit, relative to historical levels, are also impeding activities in many markets within APAC.
– Looking ahead into the next six to twelve months, we favour the mature property markets in **Australia** (Sydney and Melbourne) and **Japan**. The weaker Japanese Yen and Australian Dollar should continue to attract interest from USD-denominated investors in the near term, although we are cognizant that yield compression in the core space has pushed up capital values towards pre-crisis levels. To that end, we prefer office and logistics exposure in these markets. And within the office sector, we prefer exposure to good quality peripheral CBD assets and selective value-add opportunities.
– The **Hong Kong** office sector offers a cyclical window of opportunity, although transactions are likely to remain limited. As the main connection gateway between China and global capital markets, Hong Kong's prime office market is well positioned to benefit from China's ongoing financial liberalization. The next office supply peak will come only in 2017, creating a two-year window for prime office rents to ride this upcycle.
– On a tactical allocation basis, we recommend remaining cautious but opportunistic on **China**'s commercial property markets for the next twelve months. Our current view is that asset pricing across the board has not adjusted downwards in tandem with the weakening economic landscape and tighter credit environment for real estate. For the already limited core institutional grade commercial assets in Shanghai and Beijing, asking yields are still backward looking and have not decompressed to factor in the heightened economic risks at the moment and near future. We still, however, maintain our structural optimism on the longer term outlook of key gateway cities in China.

Chart 8: Asia Pacific – Themes and sectors to watch



Source: UBS Asset Management, Global Real Estate Research & Strategy, September 2015

Chart 9: Asia Pacific – Our views

Asia Pacific real estate markets continue to offer attractive long term fundamentals and structural advancement

Macro

- The near term economic condition for APAC likely to remain sluggish over the next one year
  - Weak China numbers and lethargic global trade will continue to cloud regional outlook
- But economic growth in APAC region will still outpace that of United States and Europe
- Policy accommodation, low inflation and ample foreign reserves to provide uplift to most major APAC economies in the face of headwinds

Key Themes

- Low interest rates and easy credit conditions supporting general investment demand
  - Transactional activity remains focused on the developed markets of Australia and Japan
  - Chase for yields – Cross border and domestic capital flows into quality assets squeezing yields
  - Further cap rate compression is expected in Australia, South Korea and Japan, where interest rates are already at historical lows
- Real estate returns in APAC region likely to be driven primarily by income growth in the next three years
  - Reasonable occupier demand and moderate rental performance across sectors in general
- Key structural factors such as urbanization, e-commerce growth, and asset rejuvenation will determine long term property performance and total returns

Markets

- We continue to favour **Australia** and **Japan** on a tactical basis
  - Low interest rate environments provide attractive yield spreads and sufficient buffer against impending interest rate hikes globally
- We think pricing and leasing risks are currently elevated in Hong Kong, China and Singapore

Sectors

- Remain overweight on **Industrial**
  - Confluence of factors: E-commerce growth, shortage of quality supply, and strong entry yields
- Cyclical on **Office**: Multi-speed office sector performance – Tokyo and Osaka offers attractive yields supported by strong occupier demand; Beijing and Hong Kong displaying cyclical rental growth window in the next year
- Structural on **Retail**: Current oversupply in all major markets although asset performance can be decoupled from overall market dynamics - Resilient consumption a function of social demographics shifts

Source: UBS Asset Management, Global Real Estate Research & Strategy, September 2015

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