

# Asian Quarterly

## Market Perspective

### Executive Summary

- The Asian economy remained in the doldrums in the first quarter, led by the anemic performance of exports. Nonetheless, China's economy is showing signs of improvement, thanks to the government's four trillion yuan (US\$584 billion) stimulus package.
- Although the region's credit market has yet to completely thaw, bank lending volume rose meaningfully in Japan and China in the first quarter.
- Asia's property markets continue to be lackluster. Investors are remaining on the sidelines due to the correction in rents and upward trend in capitalization rates.
- Demand for office space is subdued due to corporate downsizings and reluctance of tenants to commit in light of the economic downturn. Negative absorption will drive up vacancies while rents will face downward pressure going forward.
- Retail sales growth in the region has either decelerated or turned negative as a result of frail consumer confidence and belt-tightening among households. Consequently, demand for retail space, especially in prime locations, slowed in the first quarter.

### Overview

The global economic slowdown has destabilized Asia's conventional export-driven economic growth model, creating challenging conditions for the Asian real estate sector in the first quarter. The region's dependence on trade has left it vulnerable to downturns in developed nations, although governments in some countries, such as China, are injecting stimulus to breathe life into domestic economies.

The commercial real estate market reflects the broader trend. Demand for space is shrinking, exerting downward pressure on rents and property values. The credit market continues to impede any hopes for a recovery in the near term, since transaction activity is unlikely to pick up while debt financing is difficult to procure. Much like lenders in other parts of the world, banks in Asia are lending conservatively, on refinancing as well as new transactions. At the same time, investors are hesitant to re-enter the market at a time when cap rates are moving up.

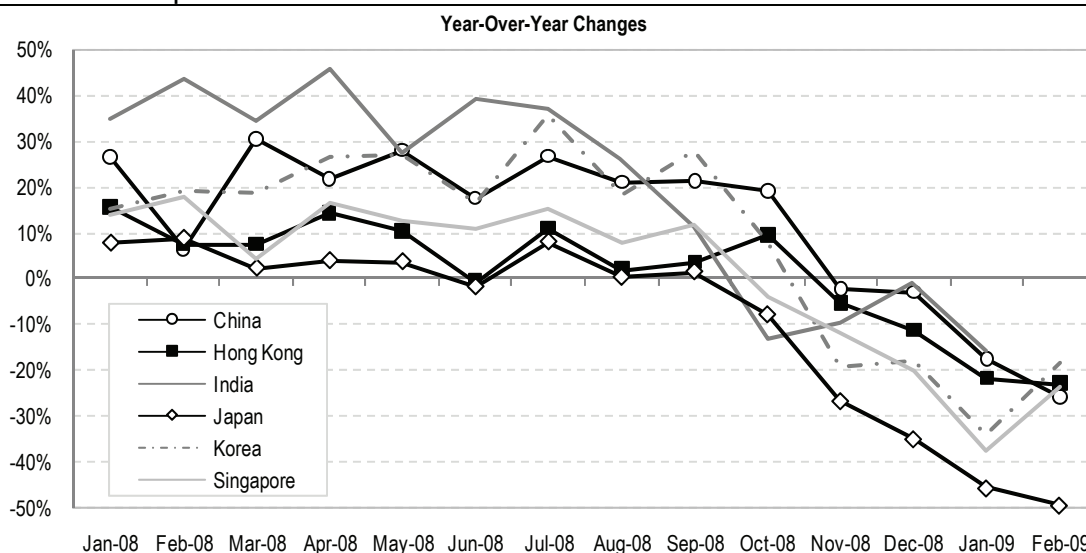
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## Economic Context

The economic downturn that started in the U.S. and Europe is posing a significant threat to Asia's economy. The World Trade Organization now projects that global trade will fall by as much as 9% in 2009, producing economic contractions in most of Asia, with the exceptions of China and India. Even in those two countries, growth rates will be much lower than was forecast prior to the crisis.

### Declines in Asian Export Values



CEIC, Pramerica Real Estate Investors Asia

Unemployment rates in Asia rose in the first quarter, especially in the manufacturing sector, which is not unexpected due to the slump in exports. Job losses also have come to the financial and business sectors, as financial institutions streamlined their operations in the region. Against this backdrop, consumer confidence weakened in the quarter, prompting a meaningful decline in household spending on non-essential items. Concurrently, monthly bank deposits in countries such as China, India, Korea, Singapore and Malaysia grew at double-digit rates in the first quarter despite the low interest rate environment. When consumer confidence returns, we believe such savings will be released to the real economy, producing a benefit to the property markets, particularly the residential and retail sectors. Interest rates are likely to remain at low levels in the short term, as inflationary pressure has dissipated in the quarter.

## Capital Markets

Asia's capital markets exhibited some positive signs in the first quarter, although overall sentiment remained extremely cautious. The J.P. Morgan Asian Credit Index ("JACI"), which measures credit risk premiums, stood at 661 bps at the end of March, down from 725 bps at year-end 2008. Indeed the risk premium has leveled off from the peak in October last year, although the pace has been rather gradual, which reflects just how cautious the capital markets have been over the past two quarters. The relatively lower risk premium could also be attributed to the various financial stimulus packages that have been introduced to inject more liquidity into the banking systems in the region. The CMBS market saw one \$720.4 million offering floated in Japan in the first quarter, according to Commercial Mortgage Alert. While

the market isn't totally shut down, in the near future any CMBS issuance will be limited to relatively small single-borrower offerings. There were a number of fully-subscribed equity offerings by Asian listed property firms in the first quarter, although the IPO market remained sluggish.

## REIT Markets

REIT markets in Asia posted mixed results in the first quarter. REITs gained in Hong Kong (14%) and Malaysia (5.3%), but J-REITs and S-REITs posted negative returns, as investors raised concerns about refinancing issues. Still, REITs mostly outperformed the broader equity markets, possibly because investors were attracted by the deep discounts to net asset values (NAV) and higher dividend yields.

### Total Returns, REITs vs. All Equities

	<u>1Q09</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
<u>REITs</u>					
Hong Kong	14.0%	-28.9%	10.4%	9.8%	2.0%
Japan	-4.7%	-49.0%	-2.3%	29.7%	13.5%
Malaysia	5.3%	-14.8%	17.8%	N/A	N/A
Singapore	-1.1%	-56.1%	2.8%	57.9%	22.2%
<u>All Equities</u>					
Hong Kong	0.2%	-52.4%	40.3%	32.6%	11.3%
Japan	-8.9%	-41.4%	-11.3%	2.9%	47.4%
Malaysia	1.0%	-39.7%	43.0%	31.4%	1.1%
Singapore	-3.7%	-50.9%	22.1%	33.9%	16.1%

Standard & Poor's Index Services (local currency)

Indeed REIT yield premiums ranged from 569 to 940 bps above long-term government bond yields. As of the end of March, the region had 83 REITs with a total market capitalization of US\$44.4 billion, which is moderately down from US\$45.2 billion at end of last year. The weighted average dividend yield fell by 30 bps in the first quarter, to 8.2%.

### Market Cap and Dividend Yields of Asian REITs

	<u>No. of REITs</u>	<u>Market Cap (US\$ bil.)</u>	<u>Average Dividend Yield</u>	<u>Risk-free Rate*</u>	<u>Risk Premium (bps)</u>
Japan	41	26.28	7.03%	1.34%	569
Singapore	21	9.93	11.40%	2.00%	940
Hong Kong	7	6.92	7.80%	1.93%	587
Malaysia	11	1.10	10.80%	1.89%	891
Korea	3	0.17	10.60%	4.68%	592
<b>Total</b>	<b>83</b>	<b>\$44.4</b>	<b>8.20% (weighted average based on market cap)</b>		

\* Risk-free rate refers to long-term government bond yields

Various Stock Exchanges; CEIC; Pramerica Real Estate Investors (as of March 31, 2009)

## **Japan**

Economic downside risk in Japan was highlighted when exports plummeted by 49% year-over-year in February, according to CEIC Data. The steep decline in exports, a key driver of economic growth, stemmed from faltering global demand and the strong Japanese yen. Amid the dramatic drop in external trade, domestic consumption slowed in the quarter as well. The government reports that, on a year-over-year basis in February, household spending shrank 3.5% and retail sales contracted by 5.8%, the steepest decline in seven years. Imports declined 43%, according to CEIC. Bank of Japan's latest *tankan* survey in March shows that large manufacturers turned more pessimistic about business prospects, which does not bode well for industrial production or the labor market. Indeed, the unemployment rate rose to 4.4% in February, a three-year high, CEIC said. The excess capacity resulting from the collapse in demand and consumption has increased the risk of deflation. Headline inflation contracted by 0.1% in February, according to CEIC. In one of the few bright spots in the Japanese economy, bank lending in Japan grew by nearly 4% year-over-year in January and February, much higher than the growth during the same months last year.

Commercial land values are falling. **Land prices in the three major urban areas (Greater Tokyo, Nagoya and Osaka) in January declined by 5.4% year-over-year, the first drop in four years, according to the government.** The decline was more pronounced in Greater Tokyo, where the government said that prices dropped 6.1% in January. Meanwhile, the tightened lending policies adopted by banks, coupled with the difficult business environment, have pushed up the number of companies filing for bankruptcy. In the first two months of 2009, corporate bankruptcies rose 25.5% over the previous year, according to Teikoku Databank America. That helped prompt **a rise in office vacancy in Tokyo's five wards to 6.1% in March, from 4.7% at year-end 2008**, according to Miki Shoji. Vacancies are likely to rise further as companies consolidate their space requirements. Newly constructed buildings will be hard to fill as demand dwindles. We believe that weak demand will persist this year and competition for tenants will lead to more concessions from landlords – rental discounts, longer rent-free periods and other incentives. With demand for class-A office space likely to remain soft and rents under pressure, cap rates for class-A offices will likely rise in the quarters ahead, possibly by 10-30 bps. Commercial land prices will see further downside as well.

Residential land prices are also falling. Land prices in the three major urban areas declined by 3.5% in January from a year ago, according to the government, which said that the decline was a bit steeper, 4.4%, in Greater Tokyo. The volume and velocity of transactions has slowed sharply. In Tokyo, only 621 new condominium units were marketed in January with a contract ratio of 67%. **The number of unsold units stood at about 4,200 units at the end of January, almost double from a year ago, CEIC said.** As part of the national budget for fiscal year 2009, the government has included steps to rejuvenate housing demand that include tax breaks of up to 6 million yen for home buyers who move into their property in 2009 or 2010. The amount of the tax break will be lowered gradually after 2010.

## **Asia Tigers**

Given their high reliance on exports to sustain growth in the region, Asia Tiger economies (mainly Hong Kong, Singapore and South Korea) will bear the brunt of the global economic downturn. In fact, February marked the fourth straight month of double-digit year-over-year declines in exports for Singapore and South

Korea, and third straight month for Hong Kong. The collapse in external demand has severely impacted the electronics sector, a backbone of the region's industrial base, which could result in more job losses. Weaker demand for industrial space drove down rents in the first quarter.

**Demand for class-A office space in the major Asian Tiger markets was similarly tepid in the first quarter, as companies – particularly in the financial and business sectors – stalled expansion plans amid the economic downturn.** Leasing demand came mainly from companies relocating to non-prime submarkets to reduce costs. At the same time, the amount of shadow space available for sublease is rising. Such space usually comes with existing fit-outs and shorter lease terms, saving lessees on initial set-up costs. The increased competition for tenants from the shadow space is putting more downward pressure on rents and is further compounding the excess supply concerns in some markets, most notably Singapore, where effective class-A office rents fell 30% in 1Q09 from 4Q08, according to Jones Lang LaSalle (JLL).

Little or no new supply is expected this year in Hong Kong (Central) and Seoul. Nonetheless, the pessimistic market sentiment and weak demand will likely put more downward pressure on rents. In the first quarter, JLL said that effective class-A office rents in Hong Kong Central fell by 25% from 4Q08. In Seoul, class-A office rents in the first quarter sagged -0.1% in the central business district (CBD), while rents in Gangnam (-1.6%) and Yoido (-0.9%) also fell marginally, according to JLL. While the tight space availability will support the current rents, the deepening economic uncertainty is likely to pressure rents going forward.

Not surprisingly, the economic downturn has led to lower transaction volume and prices in the sub-region's housing markets in the first quarter. **In Hong Kong, total residential transaction volume in 1Q09 fell by 55%, while property values dropped by almost 60%.** Nonetheless, sales activity in March was more robust than the previous months, as more buyers decided to enter the market. **In Seoul, apartment prices fell for the sixth consecutive month, by 0.3% in March from February, and 1.3% in 1Q09 from 4Q08, according to Kookmin Bank.** The negative economic prospects and the weakened labor market have taken a toll on market sentiment. The unemployment rate climbed to 4% at the end of March from 3.3% at year-end 2008, according to CEIC.

According to advance estimates from the government, **Singapore's Urban Redevelopment Authority (URA) said that home prices fell in 1Q09 by an average of 13.8% from 4Q08, the biggest quarterly decline ever.** We believe that the high-end housing market accounted for most of the decline, as buyers who purchased luxury units during construction under a deferred payment scheme (DPS) offloaded them at lower prices prior to the physical completion. The DPS essentially allows the buyers to pay up to 20% of the purchase price as a down payment and settle the balance when the project is completed. With prices falling, buyers may have difficulty financing the outstanding amount due to lower valuations adopted by the banks. The downtrend is likely to be exacerbated by the fact that 4,560 units to be completed this year were pre-sold under the DPS, the URA said. Some 76% of those high-end units sold via DPS are located in the central area, according to URA. The suburban residential market is more resilient, judging from the robust demand for new projects in suburban locations in the first quarter.

**Retail sales in the Asia Tiger region fell in the first quarter, as households tightened their belts and tourism slumped.** In February, retail sales in Hong Kong fell by 12.6% year-over-year, the first decline in 25 months, while sales also dropped in South Korea (4%) and Singapore (5.7%), according to CEIC. The contractions are likely to persist until the broader economy shows signs of recovery. Against this

background, retail tenants will become more selective and will delay their leasing decisions until consumer confidence returns. To retain and attract tenants, landlords must provide rental concessions and other incentives. Overall, we expect a slowdown in the absorption of retail space and in pre-commitments to shopping centers under construction, especially those in prime shopping districts, as retailers remain concerned about the economic uncertainties.

### ***China, India and Southeast Asia***

Despite track records of robust growth, China and India were not immune to the global financial and economic crisis in the first quarter. Chinese exports declined 21% in January and February, and imports fell by 34% year-over-year. In India, exports grew 0.6% year-over-year in the first two months, but imports contracted by 1.7%. Both nations still are expected to produce positive GDP growth this year – about 7% for China and 5% for India – thanks in part to the government stimulus measures. The government in India has taken several steps to spur lending and boost local demand. The Reserve Bank of India has reduced the policy interest rate to 5%, down 400 bps since October, with further cuts possible due to the low inflationary pressure. Inflation has dropped from its peak of 12.9% in August 2008 to less than 0.5% in March. **In China, the initial success of the government's four trillion yuan (US\$584 billion) economic stimulus package is evident in the increase in bank lending in the first quarter.** Year-over-year growth in bank lending averaged 25% per month in the first quarter, compared to the monthly average of 16% for the same period last year.

**The rise in bank lending and central government's economic stimulus measures appear to have given a lift to China's housing market in March, resulting in higher sales volume compared to the previous two months.** Price discounts and other incentives by developers have played a role as well. The government's housing price index for the 70 largest cities declined in the first quarter. However, we believe that if the sales volume is sustainable, developers will be able to reduce their inventory levels earlier than expected, which will provide strong support to current price levels, and some potential upside.

**Retail sales in China grew by 15.2% year-over-year in the first two months of the year, lower than the 20.2% growth for the same period last year.** Despite the lower growth, we believe that the underlying spending power remains intact, as evidenced by the 26% year-over-year growth in bank deposits in January and February. Once confidence is restored, which could happen quickly if the government's stimulus measures are effective, households should begin to spend some of those deposits. That turnaround will not come soon enough for the retail space markets. Retail rents remain under pressure, especially in markets such as Beijing and Shanghai, where supply is far outstripping demand at the moment.

**The class-A office market in China saw a marked slowdown in demand in the first quarter, as tenants reduced space requirements and deferred expansion plans.** New supply will exacerbate the problems in Beijing and Shanghai. In Beijing, some 25 million square feet of new class-A office space, a record high, is expected to come on-line in 2009. About 35% of the new supply will be located in the CBD. In Shanghai, occupancy rates and rents will also decline in Pudong. New supply will grow in Puxi through 2011 or 2012, but demand in 2009 will likely fall short of last year, translating to higher vacancies.

## Closing Thoughts

The first quarter was challenging for Asia's real economy and property markets. On the economic front, exports declined significantly, primarily because of the reduced demand from the U.S. and Europe. Asian manufacturers bore the brunt of the export slide and the labor market has been impacted significantly. On the other hand, bank lending in Japan and China showed signs of improvement in the first quarter, a good sign for the economy.

With corporations delaying expansion plans until the economy shows signs of stabilization, and capital expenditures declining, absorption of office space in the region will likely remain weak, especially in CBDs. We expect the decentralization trend to intensify, as more cost-conscious tenants relocate from CBDs to reduce costs. Vacancy will trend up across the board, however, driving landlords to be more competitive in asking rents. Developers will probably delay the construction of new office buildings in view of the diminishing demand, especially projects that are scheduled to be completed in 2010 or 2011. Actual completions will fall short of the projected new supply, which may improve the supply-demand equilibrium when the market recovers.

The region's domestic consumption also weakened in the first quarter, reflecting lower consumer confidence. While households will still buy necessities, spending on non-essential items will be cut significantly. Hyper marts and supermarkets will likely benefit, while upscale retailers such as department stores and specialty shops may face falling revenues. Demand for retail space will be more selective going forward, at least until the economy and labor markets stabilize. Rental concessions from landlords will help to mitigate the risk of falling occupancy and net property income, which has a significant bearing on the valuations of their retail assets, but demand for space will be soft.

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