

# Asian Quarterly

## Market Perspective

### Executive Summary

- Asian economies were off to a good start in the first quarter, despite uncertainties in the external environment. Monetary tightening is expected due to the risk of inflation, but it will be measured.
- The region's credit market remained stable in the quarter. The robustness of initial public offerings (IPOs) in Asia demonstrates the strong underlying capital flows in the region.
- Demand for class-A office space was on the upswing during the quarter, as business confidence rose and tenants relocated from secondary markets in a flight to quality.
- Asia's retail market is in position to capitalize on robust economic growth in 2010. Landlords could see growth in lease rates, which could prompt cap rates to compress.
- Barring any external shocks, Asia's real estate investment environment will remain favorable. Interest rates may rise, but the upward adjustments will be moderate in an effort to sustain economic growth.

### Economic Context

Asia's economies accelerated in the first quarter, thanks to the improvements in a wide variety of sectors. Exports and domestic consumption continued to strengthen, giving manufacturers a more positive view of industrial production prospects. Throughout the region, employment is on the rise, or at worst is stable, an indication that companies have begun hiring again after an uncertain 18-month period.

Growth has brought with it increased inflation, prompting some central banks to signal their intention to tighten monetary policy in 2010. Indeed, Australia, India and Malaysia already raised interest rates in the quarter, and more increases are likely if the inflationary environment persists. The balancing act for Asian policymakers, however, is delicate, because they don't want to curb inflation at the expense of choking off economic momentum. Probably the only exception in regards to inflation is Japan, which is expected to see another year of deflation because consumer demand is still somewhat suppressed by economic uncertainty.

Pramerica Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Tel +1 973.683.1745  
Fax +1 973.734.1319  
Web [www.pramericarei.com](http://www.pramericarei.com)

## Asian Economies Will See Rising Inflation in 2010

	2007	2008	2009	2010F	2011F	2012F
Japan	0.1%	1.4%	-1.4%	-1.0%	0.6%	1.0%
China	4.8%	5.9%	0.7%	3.5%	3.2%	3.4%
Hong Kong	2.0%	4.3%	0.5%	2.0%	2.5%	2.6%
India	6.4%	8.3%	10.9%	10.7%	5.7%	5.2%
Malaysia	2.0%	5.4%	0.6%	1.7%	2.4%	2.6%
Singapore	2.1%	6.6%	0.6%	2.2%	1.9%	1.5%
South Korea	2.5%	4.7%	2.8%	2.9%	3.0%	2.8%
Taiwan	1.8%	3.5%	0.9%	1.6%	1.8%	1.3%
Thailand	2.2%	5.4%	0.9%	3.3%	2.0%	2.2%

Economist Intelligence Unit

## Capital Markets

Fears of a possible double-dip recession in the global economy and the impact of the spiraling debt crisis in Greece led stock markets in Asia to drop as the year began. Market players were also worried that government stimulus packages would be withdrawn before the region's economies could stand on their own two feet. However, concerns began to subside when the Eurozone governments mapped out rescue packages for Greece, and economic indicators showed that Asia's economic recovery might surprise on the upside. As a result, Asian stock markets came roaring back in late February and March to the level seen at the beginning of the year.

Asia's strength is demonstrated by its domination of the global IPO market in the first quarter. Asia Pacific accounted for 66% of the \$53.2 billion total volume of IPOs globally in 1Q10, according to Ernst & Young. Nine of the 20 largest IPOs involved companies from China, Japan and South Korea, a strong indication that global liquidity continues to flow into Asia, which is arguably the least impacted region by the global credit market dislocation.

With the strong underlying liquidity in Asia, the credit market was stable in the first quarter. The J.P. Morgan Asian Credit Index (JACI) was about 240 bps at the end of March, about the same level as it started the year. Asia's CMBS market remained quiet. The region saw only one US\$200 million transaction in the first quarter, according to Commercial Mortgage Alert.

## REIT Markets

The number of REITs in Asia was reduced by three, to 79, during the first quarter. The decline came from the J-REIT market, which saw two firms merge, while two were delisted after they were acquired by other firms. Overall market capitalization of Asian REITs totaled \$63.2 billion at quarter-end, up 3.3% from the previous quarter, while the average dividend yield slid 33 bps to 6.07% at the end of March. The risk premiums for companies in Japan, Singapore and Hong Kong ebbed during the quarter, primarily due to the declines in dividend yields and the rise in government bond yields

More mergers and acquisitions are expected in the J-REIT sector. Small-cap firms with weaker balance sheets especially seem to be ripe acquisition targets for better-capitalized peers. Meanwhile, a new

industrial logistics REIT was successfully launched in Singapore in April. A few sizeable REIT listings are in the pipeline in Malaysia this year, breaking a two-year hiatus for the market.

#### Market Capitalization 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	38	31.79	5.58%	1.40%	418
Singapore	21	19.83	6.68%	2.83%	385
Hong Kong	7	9.87	6.00%	2.79%	321
Malaysia	11	1.63	8.40%	4.16%	424
Korea	2	0.11	8.20%	4.52%	368
<b>Total</b>	<b>79</b>	<b>\$63.23</b>	<b>6.07%</b>	<b>(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 Research (as of 1Q10)

After two years of large valuation swings in both directions, returns of Asian REITs in the first quarter were slight, save for Japan. J-REITs more than doubled their acquisition volume in the quarter compared to 1Q09. According to IB Research and Consulting, J-REITs acquired 39 properties totaling 229 billion yen in 1Q10, up from 108 billion yen during the same period a year ago. The transaction volume was the most since 3Q08, just before the onset of the global credit market dislocation. The ability of J-REITs to complete deals served to boost investor's confidence in the sector.

#### Total Returns, REITs vs. Property Equities

	<u>1Q10</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
<u>REITs</u>					
Hong Kong	1.6%	67.3%	-28.9%	10.4%	9.8%
Japan	8.6%	6.1%	-49.0%	-2.3%	29.7%
Malaysia	7.8%*	30.7%	-14.8%	17.8%	n/a
Singapore	-1.2%	82.2%	-56.1%	2.8%	58.0%
<u>Property</u>					
Hong Kong	0.7%	73.2%	-53.9%	57.1%	29.3%
Japan	5.7%	5.6%	-46.6%	-13.2%	21.3%
Malaysia	2.9%	37.5%	-38.5%	41.3%	55.2%
Singapore	-3.4%	85.9%	-57.3%	8.9%	75.7%

Standard & Poor's Index Services (local currency)

\*Bloomberg

## Sub-regional Markets

### Japan

Business sentiment improved in Japan in the first quarter, according to the latest *tankan* survey by the Bank of Japan (BOJ), although companies were cautious about corporate spending in light of excess capacity. The survey indicated that many companies still have excess workers, which implies that wages are likely to trend down further to the detriment of domestic demand. Japan's parliament passed a record

92.3 trillion yen annual budget at the end of March that will push total outstanding public debt to 200% of GDP, which may eventually have repercussions on the nation's credit rating.

Office vacancy rates in Tokyo increased to 8.8% in 1Q10, up from 8.1% a year ago and the highest level since August 2003, according to leasing brokerage Miki Shoji. Buildings that are less than 12 months old saw vacancies top 30% in March, up from 22.7% at the beginning of the year. The office leasing market is likely to see more downward adjustments on rents in the short term, due to the rising vacancy and competition for tenants. While new supply in 2010 is not excessive from a historical perspective, more completions are expected in 2011 and 2012, which may prompt some prospective tenants to avoid finalizing relocation plans until more supply is in the market and they have more leverage to negotiate.

The Tokyo Metropolitan Region (TMR) marketed about 4,300 new condominium units in the first two months of 2010, about the same volume as a year ago. The sales rate of new units climbed above 70%, from 65% a year earlier, according to data firm CEIC. The number of unsold condominium units stood at 6,400 at the end of February, down from almost 7,400 units at the beginning of the year.

### ***Asia Tigers***

Economic indicators in the first quarter for the Asia Tigers (mainly Hong Kong, Singapore and South Korea) pointed to a meaningful recovery of the sub-region's economy, which will result in a tightening of the employment market and boost consumer demand. Hong Kong's unemployment rate decreased to 4.6% in February from 4.9% in January. The government announced a 75% reduction of income tax and tax under personal assessment for the 2009-10 fiscal year and waived other taxes in 2010-11, all of which should support stronger household spending in the short term. Early estimates show that Singapore's economy expanded by 13.1% in 1Q10, driven by strong exports and demand for electronics. In South Korea, the unemployment rate fell to 3.8% in March, from 4.4% in February and 4.8% in January. Retail sales in February surged by 16.4% year-over-year, topping January's 10.1% growth, an indication of higher consumer confidence.

The sub-region's class-A office market improved in the first quarter after bottoming out in 4Q09. Landlords have turned more optimistic in the past two quarters as a result of the improving economic fundamentals. In Hong Kong, demand for space from financial services companies is strong, prompting effective class-A office rents in the central business district (CBD) to rise by 7.5% in 1Q10, after increasing 3.2% in 4Q09, according to Jones Lang LaSalle (JLL). No new supply is expected in the CBD in 2010, which will have a positive spillover effect on the other office submarkets in Hong Kong going forward. We expect that landlords could return to the driver seat as early as second half of 2010.

Class-A office effective rents in Singapore's Raffles Place district ebbed by about 1.4% in 1Q10, much smaller than the 4.8% decline in the previous quarter. The deceleration was supported by increased leasing activity and a flight to quality among tenants. The improved business outlook is likely to stabilize rents in the second quarter, with some upside potential for premium space. In the investment market, foreign investors bought a couple of office buildings in the CBD area in the first quarter and more sales could materialize later this year when rents show signs of rebounding. In Seoul, class-A office rents in the CBD slipped slightly, possibly because of the large new supply expected this year. Competition for tenants will ensure

that rents will remain competitive. A few large office buildings were sold to domestic investors in Seoul in the first quarter.

The improved job security and economic prospects boosted consumer confidence in the sub-region in the first quarter. Retail sales in Hong Kong rose by roughly 20% over a year ago in January and February, according to CEIC Data. Prime retail rents reflected the optimism, rising by an average of 3.7% in the first quarter, after being flat in the previous quarter, according to JLL. Prime retail rents in Orchard Road and the suburbs of Singapore were positive in the first quarter, after five quarters of declines. There is growing optimism in Singapore among both retailers and landlords, in part related to this year's opening of two major tourist destinations: the Resorts World at Sentosa and the Marina Bay Sands. Tourist arrivals in Singapore in the first two months of the year increased more than 20% over a year ago, according to CEIC. Retailers are hoping to capitalize on the increase in upscale traffic.

The sub-region's housing sector remained heated in the first quarter, causing concerns of a potential residential market bubble, especially in Hong Kong and Singapore. Most of the buying was in the luxury sector, underpinned by cash-rich local buyers. In Singapore, developers sold more than twice as many new units in the first quarter than the previous quarter, despite measures announced by the government in February in an attempt to reduce property speculation. The government is imposing a 3% levy on buyers who "flip" properties within 12 months and requiring buyers to put up a minimum 20% down payment. If those measures do not stop inflation in home prices, the government may clamp down with more regulations. The Singapore government also plans to sell more residential sites to increase new supply. Hong Kong is facing a similar situation, as purchasers remain optimistic about volume in the Special Administrative Region's (SAR's) luxury residential sector, in part due to low interest rates and increased access to mortgage financing.

### **China**

The Chinese economy continued to expand aggressively in the first quarter, after growing by 10.7% in 4Q09. Total retail sales increased by nearly 18% year-over-year in the first two months of 2010. Banks continue to lend aggressively, prompting the central bank to twice increase the required reserve ratio a total of 100 bps. That may curb lending over the short-term, but the Chinese economy's rapid expansion will continue to boost personal and corporate income, which will likely spur an ongoing cycle of lending. Another concern for the central bank was the rising inflation that emerged in early 2010. Run-away inflation could have long-term social implications, warranting an increase in interest rates in an effort to cool the economy.

China's commercial real estate market improved in the first quarter. In Beijing, multi-national corporations in the financial, bio-pharmaceutical and high-tech industries are actively sourcing class-A office space. Effective rents rose by 3.1% in the first quarter, according to JLL, reversing five consecutive quarters of decline. In Shanghai, the office market recovery is led by Pudong. Both domestic and joint venture financial institutions have been expanding in Lujiazui, prompting effective class-A office rents to increase by 4.9% in the first quarter, nearly double the increase of the previous quarter, according to JLL. Office rents in Puxi started to stabilize in the first quarter after declining almost 26% last year, JLL said.

Prices of residential units in China's 70 largest cities rose by 11.7% in March, even higher than February's 10.7% increase, according to the National Bureau of Statistics of China. The upward momentum appeared to be unabated, leading to concerns of a developing housing bubble. Some buyers are trying to enter the market before prices rise even further, which exacerbates the price increases. At the same time, the development market remains robust. Developers are paying record prices for prime residential sites, which translates to higher prices for the future end product. The underlying fundamental demand for housing is strong, due to urbanization and the rising affluence of the population, but affordability will increasingly become an issue. If prices get too high, sales are likely to cool off.

### **Australia**

The Australian economy expanded by 2.7% in 2009, up from 2.2% in 2008, thanks in part to the government's targeted stimulus, which spurred private consumption and investments. The upturn continued in the first quarter, when the unemployment rate declined to 5.3% at the end of March, from 5.5% at the beginning of the year, according to the Australian Bureau of Statistics. Many employers are suffering from a skills shortage that is being addressed in the short term by increased immigration, although the long-term issue has yet to be resolved. The growing economy has led inflation to creep up. Concerns about rising consumer prices prompted the Reserve Bank of Australia to increase interest rates by 100 bps, to 4%, between October and March. And more rate hikes are expected as the broader economy continues its uptrend in 2010.

The commercial real estate investment market is beginning to rebound after hitting the bottom in 2Q09. According to DTZ Rockwood, investment sales in the first three months of 2010 were A\$3.5 billion, a 30% increase over the preceding quarter. The lion's share of activity (A\$1.8 billion) came from the office sector. The largest transaction was the sale of Aurora Place, a 41-story mixed-use tower in downtown Sydney with office and residential space. The National Pension Service of Korea bought the building for A\$685 million. Despite that transaction, domestic investors accounted for the bulk of the purchasers.

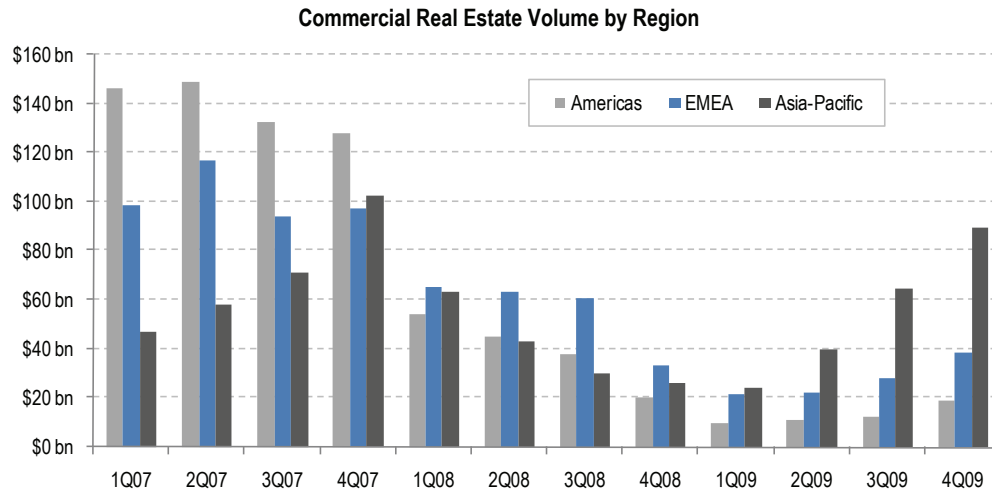
### **Closing Thoughts**

Asia's economies recovered from the global recession relatively well in the first quarter of 2010, although performance varied among the various sub-regions. Leading the pack is China, which is likely to surpass Japan in 2010 and become the second largest economy in the world, only behind the United States. China's growth is boosted by both foreign direct investments and expanding domestic consumption. Growth, supported by the exports and the services sectors, is also expected to be above-trend in the Asia Tigers (Hong Kong, South Korea and Singapore).

The outlook is not as good elsewhere. Despite the improved business morale in Japan, as measured by the BOJ's *tankan* survey, the nation's deflationary environment is expected to persist this year due to tepid consumer demand and the poor outlook for wage increases. Separately, interest rate risk emerged in some markets in the first quarter, with Australia, India and Malaysia raising their policy interest rates as a result of inflationary pressure. However, the pace of increase will likely be measured in order to not disrupt economic growth.

The Asia Pacific region saw a meaningful recovery of real estate capital flows in the second half of 2009. We believe that transaction activity will likely continue to increase this year on the back of the robust economic environment and the resiliency of the Asian property market compared to other spots around the globe. Asia, for example, has had fewer distressed sales than other regions.

### Transaction Volume is Growing



Real Capital Analytics  
EMEA = Europe, Middle East and Africa

The region's office market should continue to favor tenants in the first quarter, but rents are probably at the bottom of the cycle. Class-A office rents in Hong Kong and Shanghai have rebounded, while those in Beijing, Seoul and Singapore are very close to the bottom. We believe that rental upswing will be more apparent in the second half of this year when there are more positive economic indicators and the employment market starts to tighten again. The increasing number of lease inquiries has made landlords more positive about prospects, particularly for class-A office space. This will prompt some property owners to become less flexible in lease negotiations than they have been over the past two years.

The region's retail market should be able to capitalize on the economic recovery in 2010. General household spending is likely to increase in tandem with the growth in income, which will encourage retailers to revisit expansion plans. The insignificant decline in retail rental rates during last year's weak market illustrates the defensive nature of Asia's retail sector, which should attract more investment capital to the sector in 2010.

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Pramerica Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Tel +1 973.683.1745  
Fax +1 973.734.1319  
Web [www.pramericarei.com](http://www.pramericarei.com)  
E-mail [research.reports@pramerica.com](mailto:research.reports@pramerica.com)