

# Asian Quarterly

## Market Perspective

### Executive Summary

- Asian economies ended the year on a positive note, as fears of a severe recession proved unfounded. Growth in China and India was respectable, while other countries in the region experienced a soft landing.
- Spreads of debt products dropped in 2009 as credit markets rallied. Meanwhile, banks became more flexible in lending on commercial real estate.
- Demand for office space is selective returning. Class-A offices will be in a better position compared to second-tier assets due to a flight to quality.
- The region's retail market should improve this year as the economy finds a firmer footing. As more indicators point to economic stability, consumer spending will steadily improve, prompting retailers to revive expansion plans.
- While 2010 should be a year of opportunity in Asia, there will be risks. Asia's real estate market will continue to recover as long as the global financial markets are healthy.

### Overview

Asia rebounded from a wobbly start in 2009, when the economy was shaken by the dislocation of the global credit markets. Gloomy economic projections at the time prompted companies to put off expansions, reducing demand in the space markets. Property values fell as rental rates sagged. Banks curtailed lending severely and property transactions were minimal. Nonetheless, the situation turned around due to the unprecedented level of government support to the financial system and growth in economies around the world, creating an impressive rally in the stock markets in Asia.

The return of optimism caught many investors by surprise. Investment in Asian real estate, especially the housing sector, quickly rebounded. The rental correction in the commercial real estate market also stabilized, allaying initial fears that rents could eventually fall below the previous trough in middle portion of the decade. Indeed, 2009 ended on an upswing in Asia and the region's economic prospects are likely to be positive in 2010, thereby creating more investment opportunities in the real estate sector.

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## Economic Context

Asian economies averted the worst problems associated with the global credit market crunch, thanks to the swift government policies and massive stimulus packages. China and India posted strong growth, while the recession in other Asian countries proved to be shallow compared to other regions. Consensus forecasts call for improved GDP growth in 2010, which should boost business confidence and revive the employment market.

### Asian Economies Slowly Pulled Out of Recession in 2009

	GDP Growth in Asian Countries						
	<u>2008</u>	<u>1Q09</u>	<u>2Q09</u>	<u>3Q09</u>	<u>2009F</u>	<u>2010F</u>	<u>2011F</u>
Japan	-0.7%	-8.7%	-7.2%	-4.5%	-5.4%	1.7%	2.4%
China	9.6%	6.1%	7.9%	8.9%	8.5%	9.0%	9.7%
Hong Kong	2.5%	-7.8%	-3.6%	-2.4%	-3.6%	3.5%	4.0%
India	6.7%	5.8%	6.1%	7.9%	7.0%	6.4%	7.3%
Malaysia	4.6%	-6.2%	-3.9%	-1.2%	-3.6%	2.5%	4.0%
Singapore	1.1%	-9.5%	-3.3%	0.6%	-2.1%	4.1%	4.3%
S. Korea	2.2%	-4.2%	-2.2%	0.6%	-1.0%	3.6%	5.2%
Taiwan	0.1%	-10.2%	-7.5%	-1.3%	-4.1%	3.7%	4.2%
Thailand	2.6%	-7.1%	-4.9%	-2.8%	-3.5%	3.7%	4.5%

International Monetary Fund, government projections or announcements

## Capital Markets

Stock markets in Asia were moribund in early 2009, but they staged an impressive rebound in subsequent quarters. The MSCI Asian Pacific Index gained nearly 70% between early March and year-end, a strong indication of the so-called “hot money” flooding into the region. China led the global growth in the initial public offering (IPO) market in 2009. Globally, firms raised \$110.9 billion in IPOs during the year, which was 44% higher than the previous year, according to Dealogic. Chinese companies raised \$50.4 billion, which represented 45% of the global total and 62% more than the U.S. (\$24 billion) and Europe (\$7.1 billion) combined. The consensus is that IPO deal sizes will be larger in 2010.

Reflecting the return of investors' confidence, the risk premium in Asia's credit market continued to trend down. The J.P. Morgan Asian Credit Index (JACI) tightened to about 250 bps in December 2009, down 470 bps from beginning of the year and the lowest level since January 2008. In contrast to the robust equity market, the debt market in Asia was lackluster in 2009. Only \$1.3 billion of CMBS was issued, all in the first half of the year, according to Commercial Mortgage Alert.

## REIT Markets

Asian REITs in 2009 posted their best returns in five years. Indeed, the 2009 annual returns of REITs in Hong Kong, Malaysia and Singapore more than recovered the losses in the previous year. Prices rebounded sharply from the early part of the year, when investors were concerned about delinquency risk and whether REITs could refinance maturing debt. With debt spreads high and property values falling, speculation was rife that REITs would be forced to sell assets to pare down debt. Sentiment began to stabilize in March, when Asian governments pumped fresh liquidity into the banking system.

The wider stock market rally has also helped REITs raise new equity, strengthening their balance sheets. REITs in 2009 focused on maintaining tenants, reducing overhead and sustaining the distribution rate of net income. In 2010, Asian REITs could re-emerge as buyers of income-generating properties. The increased competition for assets could put downward pressure on cap rates.

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
<i>REITs</i>					
Hong Kong	67.3%	-28.9%	10.4%	9.8%	2.0%
Japan	6.1%	-49.0%	-2.3%	29.7%	13.5%
Malaysia	30.7%*	-14.8%	17.8%	n/a	n/a
Singapore	82.2%	-56.1%	2.8%	58.0%	22.2%
<i>Property</i>					
Hong Kong	73.2%	-53.9%	57.1%	29.3%	6.1%
Japan	5.6%	-46.6%	-13.2%	21.3%	74.3%
Malaysia	37.5%	-38.5%	41.3%	55.2%	-9.9%
Singapore	85.9%	-57.3%	8.9%	75.7%	35.2%

Standard & Poor's Index Services (local currency)

\*Data through Sept.18

There were no new Asian REITs formed last year. The total number fell to 82, due to the delisting of a Korean REIT in 4Q09. Market capitalization of Asian REITs totaled \$61.2 billion, up 35% from the previous year, while the average dividend yield slid 210 bps to 6.4% at year-end. Asian REIT risk premiums may narrow in 2010. If REIT prices trend up, dividend yields will drop relative to government bond yields.

#### 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	41	30.12	6.23%	1.30%	493
Singapore	21	19.96	6.50%	2.66%	384
Hong Kong	7	9.52	6.20%	2.58%	362
Malaysia	11	1.51	8.70%	4.29%	441
Korea	2	0.11	7.90%	4.92%	298
<b>Total</b>	<b>82</b>	<b>\$61.22</b>	<b>6.40%</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 (as of 4Q09)

## **Sub-regional Markets**

### ***Japan***

Japan's economic performance in 2009 was anemic, in part due to the global downturn and weak consumer spending. Additionally, Japanese companies have been reducing or delaying new investments in plant and equipment. According to Japan's Cabinet Office, GDP rose by 1.3% in the third quarter, much less than the initial estimate of 4.8%, as capital spending fell by an unexpected 24.8% year-over-year. To spur the economy, the government unveiled a new stimulus package totaling JPY7.2 trillion (\$81 billion) or about 1.5% of GDP. Since September 2008, Japan has announced four stimulus packages totaling more than JPY29 trillion (\$326 billion), the third largest globally after the U.S. (\$787 billion) and China (\$586 billion). The International Monetary Fund (IMF) projects that Japan's economy contracted by 5.4% in 2009 but will grow by 1.7% in 2010.

Increasing office vacancy rates in Tokyo, especially in newly-completed buildings, pushed rent rates lower in 2009. The vacancy rate rose to 8.1% at year-end, up from 4.7% the prior year. Large blocks of vacant space are increasingly common as corporations downsize their workforces. The lack of new demand drove down rents and put landlords in a difficult spot. The class-A office market will likely remain flat in 2010, because capital budgets are tight and any expansion plans will be carried out slowly.

Office property sales in Tokyo were thin in 2009 due to the constrained credit market and wide gulf between buyers and sellers. Transaction volume fell 39% year-over-year in the first three quarters of 2009, according to Real Capital Analytics (RCA). Despite the subdued market sentiment, investor demand re-emerged in the second half, which should prompt cap rates to level off. Interest rates will likely remain low in 2010. The low cost of debt will be conducive to the investment market. Sales may also pick up if the economy improves and rents recover.

The total number of new condominium units marketed in the Tokyo Metropolitan Region (TMR) through November fell by 6,000 from the same period a year ago. The lower supply reflected a strategic change, as developers launched fewer units amid the economic uncertainty and a weak labor market. Nonetheless, lower prices pushed the sales rate of new units in the TMR to 70% through November 2009, up from 63% during the same period a year ago, according to data firm CEIC. The number of unsold new condominium units fell to 6,800 units in November from 12,400 units at the beginning of the year, CEIC said.

### ***Asia Tigers***

The Asia Tigers (mainly Hong Kong, Singapore and South Korea) experienced a mild recession in 2009, although it was better than the severe contraction that was feared at the start of the year. The improvement was more obvious in the second half of the year. The sub-region's economic prospects in 2010 should be sanguine, but not without challenges, as export demand could be volatile and governments may need to stimulate their domestic economies to increase demand. Private-sector investments will also be crucial for a more sustainable economic recovery. Singapore, for example, will see the completions of two Integrated Resorts in 2010, which will boost tourist arrivals and retail spending.

The sub-region's class-A office market underperformed in 2009, which was not totally unexpected. The lack of new demand and corporate downsizings prompted vacancies to rise and asking rents to fall significantly. The markets with the biggest decline in effective rents included Singapore (-51%) and Hong Kong (-36%). Seoul was resilient, with effective rents declining by 3.2%. The financial and business sector, a key driver of office demand, absorbed little space in 2009. Nonetheless, inquiries for class-A office space in central business district (CBD) areas rose in the fourth quarter, probably driven by tenants' desire to move to higher-quality space. While we do not expect a V-shaped rebound of the office market, we believe that the rental correction has ended and further downside is limited. The market recovery will be a function of the economic performance of office space occupiers, especially those in the financial sector.

Consumer confidence in the sub-region recovered toward the end of 2009, as the economy showed signs of stability. Consumer spending is strongest for basic necessities, while sales of luxury items such as automobiles and jewelry remain tepid, which is an indication that the general public is still wary of the economy and its impact on household income. While the holiday season in the final quarter of 2009 brought some cheer to retailers, 2010 will be another challenging year. The opening of the Integrated Resorts project should serve to boost retail sales in Singapore.

The sub-region's housing sector was a bright spot in 2009. Fear of a global economic depression was short-lived and the stock market rally re-channeled some of the liquidity to the residential market. As a result, sales volume recovered significantly, which prompted developers to be more aggressive in their pricing. At the same time, competition among banks for market share cut the price of mortgages, resulting in an environment conducive to home purchases. In Hong Kong, home prices increased by more than 30% in 2009. In Singapore, home prices increased by 24% in the second half of 2009, putting them only 7% below peak levels in 2Q08. While the resiliency of residential prices is a pleasant surprise, it has also prompted the government to increase land and building supply to minimize the risk of a new housing bubble, which can have painful implications on the wider economy. Going forward, market sentiment should remain optimistic in 2010 as long as sales volume remains strong and bank financing remains available.

### ***China and India***

Despite the fragile external environment, India's economy remained on the growth track in 2009, thanks to the rebound in exports and strong domestic demand for consumer goods that was stoked by government stimulus measures. GDP growth is expected to reach 7% in 2009. However, a surge in food prices pushed India's inflation rate to 4.8% in November, compared to 1.34% in October. Inflation is projected to rise to 6.5% by March, which may prompt the central bank to tighten monetary policy.

Rising vacancy rates in shopping centers in India led retail property rents to fall by up to 35% in 2009, according to Cushman and Wakefield. That has prompted owners to opt for a lease structure with turnover rent, in which tenants' rental payments are a percentage of revenue rather than a set monthly rate, as a major component of retaining tenants. Residential sales took a dip in 2009 as buyers shelved purchases in view of the global downturn. Nonetheless, market activity should pick up in 2010, as attractive pricing should mitigate concerns of a potential interest rate increase.

The Chinese economy managed to expand by more than 8% in 2009, thanks to the massive RMB4 trillion stimulus package directed mostly to infrastructure and bank lending. In the first 11 months of 2009, total

bank lending soared to RMB9.2 trillion, nearly twice the government's initial target of RMB5 trillion for the year, and is on track to hit a record RMB9.5 trillion. The resulting liquidity led to a stock market rally and increase in property prices, especially in the residential sector. According to RCA, seven of the 10 most active real estate markets in the world in 2009 were found in China, led by Beijing and Shanghai. In 2009, property sales in China totaled \$118.3 billion, accounting for roughly 35% of the \$338 billion of global property transaction volume and 74% of the \$159 billion total in Asia. Most of the transactions in China involved residential development sites, a clear sign that developers were bullish about the sector.

Residential prices recovered meaningfully in the second half of 2009, after a lackluster performance in the first six months. Home prices in the top 70 large- to medium-sized Chinese cities rose 5.7% year-over-year in November, according to the National Bureau of Statistics. The pace of land sales and increase in home prices prompted the government to announce measures to cool sentiment. One measure will tighten land sale rules for developers. The government also is increasing the property sales tax. Homes that are re-sold within five years of purchase will now be charged a 5.5% business tax. Previously, the tax only applied for two years. The law is intended to prevent speculators from “flipping” houses for profit.

The Chinese government is faced with an ongoing balancing act between monetary policy and worries about asset bubbles. More policy changes are expected to be implemented in the residential market to ensure that prices grow in line with the wider economy. The government also faces challenges such as anemic export demand from the U.S. and Europe, and signs of rising inflation in the mainland. Local consumer prices rose in November, the first increase in nine months.

## **Closing Thoughts**

Having weathered the global credit crunch and the ensuing economic downturn, economies in Asia have emerged in reasonably good shape. The region's economy experienced a soft landing in the thick of the global economic downturn. Emerging markets such as China and India led the way out of the crisis with solid growth in 2009, thanks to government stimulus packages. Asia's economic prospects in 2010 will probably surprise on the upside, supported by the proactive measures of the region's governments. While the global credit crisis is likely in the rear view mirror, systemic risk will continue to be a sensitive issue in 2010.

A key factor for the health of the region's real estate sector is the restoration of credit. Banks are becoming active again, although they are wary of the problems created by the credit bubble and therefore will use more conservative criteria when underwriting loans. Underwriting models will encompass more realistic loan-to-value ratios and reflect the underlying potential risks. Highly leveraged transactions will be scarce, as investors are wary of downside risk.

Demand for office space in Asia is selectively returning, but we expect more tenant relocations than corporate expansions in 2010. We won't see a significant increase in headcounts until corporate profits become more meaningful. Class-A offices will capture the lion's share of demand, as the substantial correction in rents over the past 12 months makes them more affordable and a better value relative to second-tier locations.

Asset valuations in the region dipped in the early part of 2009, due to lower rent levels and rising cap rates. However, appraised values rebounded toward the end of the year and should remain stable in 2010, as cap rates trend back down and rents stabilize. Income-generating assets, especially retail properties, will regain investor confidence, supported by the vast population base and the growing affluence of Asian households.

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