

Asian Quarterly

Market Perspective

Executive Summary

- Sentiment in Asia saw a marked improvement in the second quarter. Early signs of economic stabilization brought upon by factors that include the various government stimulus packages in the region fueled a stock market rally.
- Credit market tension has begun to ease, leading to meaningful growth in bank lending.
- Asia's property investment markets saw slightly higher transaction volume in the second quarter over the first quarter. That could signal that investor confidence is slowly returning, although the volume remains much smaller than a year ago.
- Rental demand in the region's office markets came mostly from tenant renewals instead of expansions. The overall sentiment remained cautious, and cost-conscious tenants were taking advantage of the current market to negotiate lower rents.
- Residential sales were robust, boosted by low interest rates, strong underlying pent-up demand, high saving rates and improved availability of mortgage financing.

Overview

Talk of "green shoots" in Asia emerged and gathered momentum throughout the second quarter, which propelled the region's stock markets to rise by about 46% on average since early March. The incipient economic recovery has likely started, although it will be uneven among the different Asian countries. The region's resiliency was strengthened by the various pump-priming measures announced by the central governments, which helped rebuild confidence and spurred domestic investments. Spreads in the Asian credit market also narrowed in the quarter, while bank lending showed signs of normalizing. Against this backdrop and supported by the latent demand, there was a noticeable pick-up in the region's residential markets in the quarter. The continuation of the current stabilization phase will be a pre-requisite for any meaningful return of real estate investment capital. In the meantime, positive leading indicators must continue over a longer period of time before a sustainable rebound can be proclaimed.

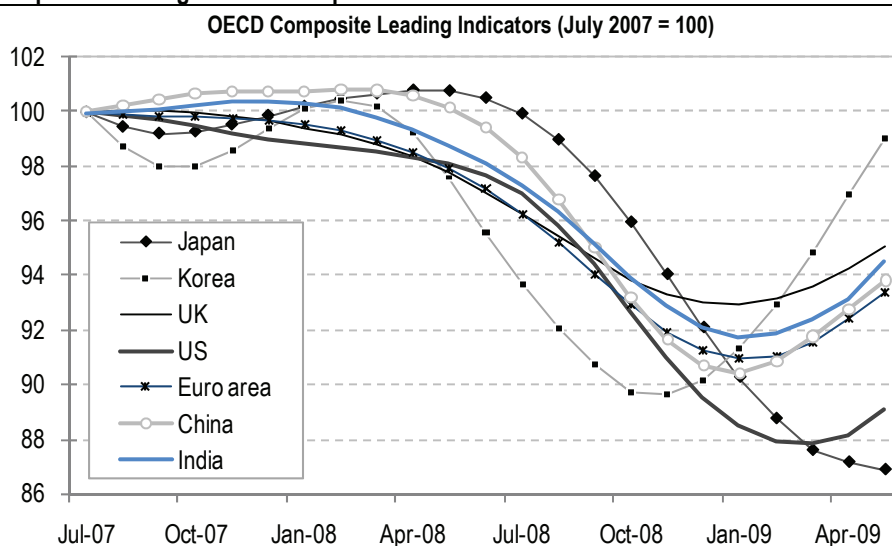
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Economic Context

In light of the continued weakness in the external environment in the second quarter, it is not surprising that Asia's exports remained in the doldrums. Nonetheless, the regional slowdown showed signs of abating in the second quarter, as evidenced by the Organization for Economic Co-operation and Development's (OECD) Composite Leading Indicators index.¹ The index suggests that the large economies in Asia have bottomed. As a result, prospects have become less negative and a period of stabilization may be underway. This is cemented by the substantial stimulus and interest rate reductions around the region. The low interest rate environment will likely persist, as there is little evidence that consumer prices are trending up. Economies in South Korea, China and India are gradually emerging from lulls, while the pace of decline of the Japanese economy is slowing.

Composite Leading Indicators Improve in Most Countries



OECD; Pramerica Real Estate Investors Asia

Capital Markets

Equity markets around Asia posted an impressive 46% gain on average between the low point in early March and the end of June, according to the MSCI Asia Pacific index. The healthy gains reflect investors' increasing appetite for risk, which also helped fuel a 46% rise in initial public offerings (IPOs) globally. According to Ernst & Young, the number of IPOs increased in the second quarter to 76 from 52 in the first quarter, while the total value increased seven-fold, to US\$9.9 billion in 2Q09 from US\$1.4 billion in the first quarter. Asia Pacific saw 45 IPOs in 2Q09, with a total value of US\$3.3 billion, of which 87% emanated from the China and Hong Kong markets. Against this background, bond spreads in Asia tightened in 2Q09, an indication that the credit market tension has somewhat eased. The J.P. Morgan Asian Credit Index (JACI), which measures credit risk premiums, tightened to 399 bps at the end of June, down from 657 bps at the end of March. The CMBS market in Asia, however, remained inactive, with only two offerings totaling US\$300 million in the second quarter, according to Commercial Mortgage Alert.

¹ The CLI is designed to provide early signals of turning points (peaks and troughs) between economic expansions and slowdowns.

REIT Markets

Asian REITs posted double-digit price returns in the second quarter, rebounding from a subdued performance in 1Q09. Top performers were REITs in Singapore (29.1%) and Japan (17.6%). The improvement in market conditions enabled several REITs to refinance debt during the quarter. In addition, some REITs have managed to increase their war chests by issuing equity. In Japan, a new fund to assist J-REITs with financing issues will be set up in the third quarter. The fund, targeted to raise JPY300 billion to 500 billion, will be seeded by investors that include the state-run Development Bank of Japan, major developers and financial institutions.

Total Returns, REITs vs. All Equities

	<u>2Q09</u>	<u>1Q09</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
<u>REITs</u>					
Hong Kong	16.9%	14.0%	-28.9%	10.4%	9.8%
Japan	17.6%	-4.7%	-49.0%	-2.3%	29.7%
Malaysia	13.7%	5.3%	-14.8%	17.8%	N/A
Singapore	29.1%	-1.1%	-56.1%	2.8%	57.9%
<u>All Equities</u>					
Hong Kong	41.4%	0.2%	-52.4%	40.3%	32.6%
Japan	18.2%	-8.9%	-41.4%	-11.3%	2.9%
Malaysia	26.1%	1.0%	-39.7%	43.0%	31.4%
Singapore	45.5%	-3.7%	-50.9%	22.1%	33.9%

Standard & Poor's Index Services (local currency)

Overall, the number of Asian REITs remained at 83 as June 30, with a total market capitalization of US\$52.4 billion, 18% higher than a quarter ago. The average dividend yield stood at 7% at quarter-end, representing a 120-bps decline from three months ago. Yield spreads over long-term government bonds remained attractive at between 386 and 796 bps.

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	30.31	5.97%	1.36%	461
Singapore	21	12.75	9.00%	2.59%	641
Hong Kong	7	7.91	7.20%	2.64%	456
Malaysia	11	1.26	9.90%	1.95%	796
Korea	3	0.22	8.50%	4.64%	386
Total	83	\$52.4	7.00%	(weighted average based on market cap)	

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

Various Stock Exchanges; CEIC; Pramerica Real Estate Investors (as of 2Q09)

Sub-regional Markets

Japan

While the Japanese economy remained patchy, there are some signs that it is close to bottoming out, in part due to the sizeable stimulus packages implemented by the government. For example, consumer confidence in May rose for the fifth straight month, while household spending rose unexpectedly by 0.3% year-over-year and by 2.2% over April, according to The Cabinet Office. Industrial production increased by 5.9% month-over-month in May, the third consecutive rise, as manufacturers replenished inventories, according to the Ministry of Economy, Trade and Industry. The Bank of Japan (BOJ)'s latest *tankan* survey in June shows that large Japanese companies were less pessimistic about the economy in the second quarter compared to the preceding one, while further improvement is expected going forward. The central bank also raised its economic outlook twice this quarter after announcing that the economy has bottomed out. On the other hand, the unemployment rate climbed to 5.2% in May, the highest in almost six years. Exports remained weak, weighed by the global economic slowdown and strong Japanese yen. Exports in May amounted to about 60% of the same period a year ago. On balance, however, Japan's aggressive fiscal policies should help the country weather the global downturn and provide economic stability.

The availability of more credit to local enterprises as part of the government stimulus package led to a declining pace of corporate bankruptcies in the second quarter. Total bankruptcies in the second quarter grew by 14.6% over 2Q08, a modest deceleration from the 18.7% growth rate in 1Q09, according to Teikoku Databank America. In Tokyo's class-A office market, the average vacancy of the five wards stood at 7.25% in June, 29 bps higher than May, according to Miki Shoji, following increases of 17 bps in May and 74 bps in April. The average vacancy was 6.7% for older buildings and 32.9% for buildings completed within the last 12 months. New buildings are hard to fill because their rents are about 50% higher than older stock. Consequently, until demand rebounds, we expect to see more construction delays of new office buildings. This will result in fewer completions in the near term, which can mitigate the supply-demand imbalance.

The residential market in the Tokyo Metropolitan Region continues to see a steady decline in unsold new condominium units, which signals that the housing market in Tokyo may be more affordable to new buyers who are willing to enter the market, despite the economic uncertainty. In June, the number of unsold new condominium units stood at 7,928, down from 8,846 in March and 12,427 at the end of last year, according to CEIC Data. Further declines in the number of unsold units will provide more support to the current pricing. In fact, condominium prices edged up about 4.6% in June from April. We believe that further price upside is possible, as long as the unsold inventory level continues to trend down.

Asia Tigers

Asia Tiger economies (mainly Hong Kong, Singapore and South Korea) remained soft in the second quarter, pressured by the weak exports and compounded by the uncertain labor market, which will have negative implications on domestic consumption. While governments' fiscal spending will help to spur investments and create jobs, the sub-region's fate is largely tied to the external environment. In the meantime, the current fiscal stimulus is helping to mitigate the impact of the global downturn. For example, South Korea's gross domestic product (GDP) grew by 0.1% in the first quarter over 4Q08, thanks to

US\$21.3 billion of government stimulus, according to the International Monetary Fund (IMF). In previous downturns, the Asia Tigers rebounded in line with strengthening export markets. Nonetheless, the current global downturn has introduced new economic challenges to the sub-region, which will likely require governments to take additional measures to mitigate the impact of the downturn.

Demand for class-A office space in Hong Kong and Singapore in the second quarter was weak, as sublets or vacant “shadow” space are competing with new space. Much of the “shadow” space was caused by the large number of tenants backing out of commitments made prior to the economic downturn. In Singapore, the amount of shadow space totaled about 800,000 square feet in June, nearly double from March, according to Jones Lang LaSalle (JLL). That said, the decline in class-A office rents showed signs of decelerating in the second quarter. Class-A rents in Raffles Place fell by 13% in 2Q09, less than half of the 30% decline in the first quarter. Similarly, class-A office rents in Hong Kong Central fell by 13% in 2Q09, smaller than the 26% decline in the previous quarter, according to JLL. The class-A office market in Seoul is more resilient, registering minimal rental declines in the second quarter. Going forward, we believe that the sub-region’s class-A office markets will be subject to downside risks such as decentralization by increasingly cost-conscious tenants. One major question concerns demand from international financial institutions, who are the key drivers of Asia’s class-A office market. The credit crunch has brought about a fundamental change to the global banking system, which will impact the sector’s future business plans, including real estate requirements in Asia.

After a rather lackluster first quarter, the sub-region’s residential market surprisingly heated up in the second quarter. Low interest rates and the significant price correction over the past year have prompted potential buyers to take a second look at the market. In Singapore, sales of new residential units by developers in the second quarter were 77% higher than the first quarter and more than three times the same period a year ago. According to the government’s preliminary estimates, the overall private residential price index fell by 5.9% in 2Q09, compared to a 14.1% decline in the first quarter. The buying momentum in the private market is also supported by the households upgrading from the public housing sector, where about 80% of the population resides. In Hong Kong, the number of residential sales transactions and volume in 2Q09 more than doubled from the first quarter, according to the Land Registry, a strong reflection of the underlying purchasing power of home buyers.

In Seoul, the housing market also showed signs of improvement in the second quarter, possibly because of improved consumer confidence in the economy’s prospects. After a minor dip in the first quarter, housing prices rose in the second quarter, according to Kookmin Bank. Average housing prices rose by 0.7% in the quarter, although they remain 1.3% below levels of a year ago. At the same time, apartment transaction volume in Seoul in April and May was already 34% higher than the first quarter. Going forward, interest rates in Korea are likely to remain low, which bodes well for the housing market. Any price upside in the second half will largely depend on how the economy pans out.

Retail sales in Hong Kong and Singapore fell 10.3% in May and 6.2% year-over-year, according to CEIC. The declines could be partly attributed to a year-over-year drop in tourism, which fell by 1.4% in Hong Kong and 12% in Singapore between January and May, in large part due to concerns about the H1N1 “swine flu.” Looking ahead, retail rents in Hong Kong will likely remain stagnant until consumer spending improves. In Singapore, retail rents in prime Orchard Road area will face more competition due to the large volume of

new completions in 2009 and 2010. In the suburban areas, retail rents are more resilient due to the limited new supply and the stable demand.

In South Korea, retail sales rose by 1.9% year-over-year in May, after a 1.4% decline in April, due to the strengthened consumer confidence in view of the government's fiscal stimulus. The increasing number of tourists visiting South Korea, supported by the weak Korean Won, has also contributed to the increase in retail sales. In the first five months of the year, the total number of tourists rose by almost 19% from a year ago. We believe that prime retail rents in Seoul will firm up going forward, in view of the further stabilization of the economy.

China and India

India's GDP expanded by 6.7% in the year that ended March 31, the slowest pace since 2003. This year, the government expects the economy to accelerate by 7% to 7.5%. India's industrial output rose year-over-year by 2.7% in May and 1.4% in April, although exports fell in May by 18.4% from a year ago, according to CEIC. Compared with other emerging economies, India's economic growth model is less dependent on exports, which amount to only about 20% of GDP. The lion's share of growth (55%) emanates from the service sector. This is expected to help mitigate the adverse impact of the global recession, because domestic spending has not been severely impacted. In the housing market, reduced mortgage rates have attracted some buyers back to the market, albeit slowly in light of the slowing economy. Demand will probably improve when the economy expands at a greater pace.

In China, the government's proactive fiscal and monetary policies have boosted the economy. Second quarter GDP grew by almost 8%, after expanding 6.1% in the first quarter as reported by the National Bureau of Statistics. The 8% growth was driven by the vast amounts of infrastructure projects started as part of government's pump-priming. China's manufacturing sector shows signs of expanding, as evidenced by June's Purchasing Managers' Index of 53.2, up marginally from 53.1 in May.² Growth in China's real estate investment rose by 12.7% year-over-year through May, although it is still lower than the same period last year. The World Bank revised China's 2009 GDP forecast up to 7.2% from 6.5%, while the OECD's forecast rose to 7.7% from 6.3%.

China's housing market also showed signs of bottoming out in the second quarter. In June, the overall residential price index rose by 0.2% versus a year ago, reversing the year-over-year declines of 0.6% in May and 1.1% April, according to the National Development and Reform Commission. Residential sales volume in China rose significantly in the second quarter, prompted by the correction in prices since late last year, the government's fiscal stimulus and relaxed bank lending. In fact, overall bank lending rose by nearly 32% year-over-year on average in the second quarter, after a 25% jump in the first quarter. Amid the rejuvenated market, developers resumed banking new land in the second quarter, and have bid aggressively on land auctions, particularly in first-tier cities such as Beijing and Shanghai.

The class-A office leasing market in Beijing remained soft in the second quarter, due to the incoming new supply and resistance from tenants. Landlords have become more realistic about rental expectations, particularly in the midst of a global economic downturn. They have been forced to provide concessions such as fit-out cost subsidies and longer rent-free periods. Retaining existing tenants has become a top

² A reading above 50 indicates expansion.

priority for building owners, especially for markets such as Pudong (Shanghai) and Beijing, where surplus supply is anticipated. In Puxi (Shanghai), however, new supply in 2009 and 2010 will be relatively less than Pudong and therefore the upward pressure on vacancy will be less pronounced.

According to CEIC, retail sales in China grew by 15% year-over-year in the first half of the year, helped by the government's stimulus measures, which include reducing sales taxes on small cars and subsidizing farmers that buy agricultural equipment. The growth in retail sales was noticeably lower than the 21.4% growth in the same period last year, but similar to the pace in 2007. The retail space market in Beijing remained challenging, due to ample new supply and more subdued expansion activity from retailers. Developers have delayed project completions in a bid to secure higher occupancy before opening. In Shanghai, new supply of prime retail space will be limited, which should help reduce vacancies.

Closing Thoughts

While the Asian economy is not entirely out of the woods yet, market sentiment became less bearish in the second quarter. Indeed, the economic slump that was previously projected has been revisited and the current forecasts are pointing to a less severe contraction. The pace of decline in the second quarter was less pronounced than the preceding quarter, which is viewed positively by market players. The various fiscal stimulus packages announced by the Asian governments have turned out to be a stabilizing factor to regain market confidence. The trend is likely to extend into the third quarter, with more signs that the region's economy is at the bottom.

Against a less volatile external environment, Asia's property market saw some improvement in sentiment in the second quarter, as the slide in rents and capital values decelerated from the previous quarter. We believe that Asia's real estate market will likely stabilize as long as the regional economy continues to see positive signs ahead.

That said, the severity of the global economic downturn likely means that the road to recovery will be relatively long and the momentum will be gradual. Under such circumstances, we believe that Asia's real estate investment market is bottoming out, albeit slowly. Opportunistic investors will re-emerge gradually and will seek quality investments in core Asian markets such as Tokyo, Seoul and Singapore. Accordingly, transaction volume will increase but – given that buyers will remain selective – will remain a fraction of pre-crisis levels. The availability of bank financing will also be crucial to support the transaction market. Without active sources of debt, returns will not be attractive enough to entice investors back to the region. Overall, the current economic stabilization in Asia should help bolster real estate investor confidence, which is needed for a meaningful recovery of the region's property market going forward.

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