

Asian Quarterly

Market Perspective

Executive Summary

- Economic indicators in the third quarter point to stability in Asia. China and India are key sources of growth, while smaller Asian countries will likely see soft landings in 2009.
- Credit spreads in Asia continued to trend down in the quarter, a sign of the growing confidence of investors. That has made banks more willing to finance commercial real estate.
- Sentiment in the property market grew more positive in the quarter, which helped to ease the downward pressure on office rents and capital values. However, the lack of capital investments and new developments will delay any market recovery.
- Consumer spending in the region remains selective. Retailers are holding back expansion plans until economic fundamentals strengthen further.
- The housing markets in China, Korea, Hong Kong and Singapore were bright spots in the quarter. Demand for units has translated into high sales volume and rising prices.

Overview

One year after the collapse of Lehman Brothers and the banking crisis that almost brought the global economy to its knees, Asia has recovered remarkably well. The doom and gloom that pushed the Asian stock markets down by an average of 39% between September 2008 and March 2009 has been lifted. With Asia's economies improving on the back of government economic stimulus packages, the region's stock markets rose by an average of 64% from the trough in early March. The rebound caught many investors by surprise.

Notwithstanding the lingering uncertainty about growth in many regions of the globe, Asia's prospects appear to be on solid ground. The International Monetary Fund's latest GDP forecasts for Asia predict respectable growth of 5.0% in 2009 and 6.8% in 2010, mostly led by China and India. Against this background, we believe that Asia's real estate markets will stabilize even further during the rest of the year.

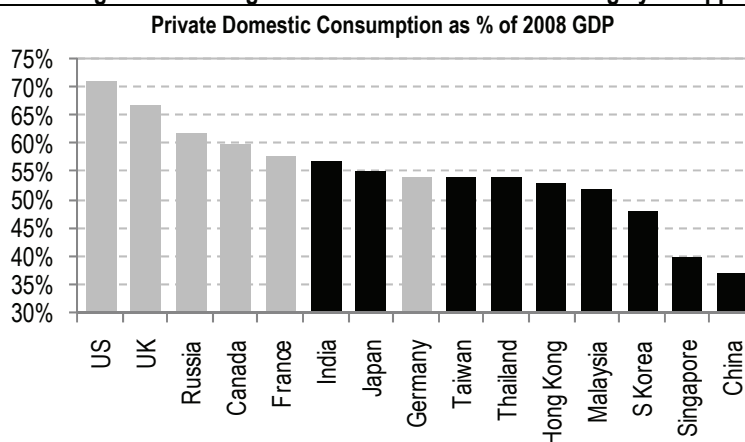
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Economic Context

Asia managed to avoid the brunt of the negative impact caused by the drop in external demand from the U.S. and Europe. This was done in part due to strong monetary and fiscal support from the region's governments, which increased public expenditures, injected liquidity into the banking system and kept interest rates low. Asia's currency market also remained stable, thanks to the strong foreign reserves that the various nations have built up since the Asian financial turmoil in the mid-1990s. These factors and others have contributed to rebuild confidence, as evidenced by the stock market rally since March this year. The region's underlying purchasing power is another potential boon for the economy. Private domestic consumption in Asian countries lags most of the developed world, meaning there is a large consumer market that has the potential to be tapped.

Asia's Large and Growing Domestic Consumer Markets Largely Untapped



McKinsey Global Institute: "A Consumer Paradigm for China," August 2009

Capital Markets

Asia not only saw a stock market rally in the third quarter, but there was a resurgence of initial public offerings (IPOs) and an increase in risk appetite. Some 63% of the \$38 billion of IPOs issued globally in 3Q09 involved mainland Chinese companies, while Indian firms accounted for 7.2% of the total, according to Ernst & Young. Indeed, seven of the 10 largest IPOs in the quarter involved Chinese companies. The MSCI Asia Pacific Index rose by 12% in the third quarter, although the upward momentum trailed the preceding quarter. The rally has created concerns about sustainability, and whether the markets have overshot. The possibility that government stimulus programs will be wound down and the soft labor market data have moderated the rally.

On the debt side, no CMBS was floated in Asia in 3Q09, according to Commercial Mortgage Alert, although Asia's credit market continued to normalize in the quarter. The J.P. Morgan Asian Credit Index (JACI), which measures credit risk premiums, tightened to 300 bps at the end of September, down almost 100 bps from three months ago, bringing the JACI back to June 2008's level.

REIT Markets

Asian REITs continued to post positive returns in the third quarter. Singapore, which regained investors' favor after a disappointing performance last year, was the top performer at 30.6%. Asian REITs have been able to raise both equity and debt, while borrowing spreads have eased between 50 and 100 bps. Property acquisitions by REITs are scarce, as dividend yields remain relatively high, making it challenging to acquire properties at such entry yields. However, the ongoing improvement in the flow of credit in Asia will lay the groundwork for future acquisitions.

Total Returns, REITs vs. Property Equities					
	3Q09	2Q09	1Q09	2008	2007
<i>REITs</i>					
Hong Kong	8.6%	16.9%	14.0%	-28.9%	10.4%
Japan	2.8%	17.6%	-4.7%	-49.0%	-2.3%
Malaysia	9.1%	13.7%	5.3%	-14.8%	17.8%
Singapore	30.6%	29.1%	-1.1%	-56.1%	2.8%
<i>Property</i>					
Hong Kong	12.4%	45.3%	0.1%	-53.9%	57.1%
Japan	-6.3%	37.1%	-16.7%	-46.6%	-13.2%
Malaysia	5.3%	29.7%	-1.9%	-38.5%	41.3%
Singapore	17.6%	55.3%	-9.0%	-57.3%	8.9%

Standard & Poor's Index Services (local currency)

The number of Asian REITs (83) was unchanged during the quarter. Total market capitalization rose by 15.3%, to US\$60.4 billion, as share prices rose. The average dividend yield slid 60 bps to 6.4% at quarter-end, or 210 bps less than the peak in the last quarter of 2008. Dividend yields mostly hovered at about 400 bps over long-term government bonds. The exception was Korean REITs, which had a spread of 749 bps at Sept. 30.

Market Capitalization and Dividend Yields of Asian REITs

	No. of REITs	Market Cap (US\$ bil.)	Average Dividend Yield	Risk-free Rate*	Risk Premium (bps)
Japan	41	32.71	5.65%	1.30%	435
Singapore	21	17.58	7.20%	2.45%	475
Hong Kong	7	8.49	6.80%	2.36%	444
Malaysia	11	1.46	8.90%	4.18%	472
Korea	3	0.17	12.30%	4.81%	749
Total	83	\$60.4	6.40%	(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 3Q09)

Sub-regional Markets

Japan

The decades-long reign of the Liberal Democratic Party ended in August as a result of a landslide victory for the Democratic Party of Japan (DPJ), which hopes to boost the stagnant economy by encouraging consumer spending and increasing domestic demand. Nonetheless, the DPJ has yet to highlight any clear policies, prompting concerns over the sustainable impact of the fiscal package and rising risk of deflation. While indicators such as household spending, employment and business confidence are rising, companies and consumers still are not motivated to spend, even as producers cut prices of goods. Core inflation fell 2.4% in August, (excluding fresh food), the largest decline in 28 years and sixth consecutive monthly decline. Lower prices could trigger a vicious cycle with depressed company profits leading to production and wage cuts, which would exacerbate the downturn. The Japanese export market is likely to be hurt by the strong Yen against the U.S. dollar. The Yen appreciated 6.3% in the third quarter and 19% since August 2008. Despite lower import costs, consumption is unlikely to surge if domestic spending remains selective. The risk of deflation will likely prompt the central bank to maintain the current low interest rate environment in Japan in the short term.

Amid the lingering economic uncertainty and the impact on the real estate market, Japan's land prices fell at their fastest rate in five years, according to the Ministry of Land, Infrastructure, Transport and Tourism. In Tokyo, commercial land prices fell by 11% year-over-year in the first half of 2009, the steepest in 13 years. While business confidence was less bearish in the third quarter, as shown by the Bank of Japan's (BOJ's) *tankan* survey, companies remain cautious in their expansion plans, which will continue to put downward pressure on office rents. Even though the unemployment rate fell by 20 bps to 5.5% in August, the labor market remains soft and job availability stood at only about four jobs available for every 10 applicants, according to the Labor Ministry. Several office J-REITs have suggested that they plan to reduce asking rents. Yet class-A office vacancy in central Tokyo increased only marginally in the third quarter, which could mitigate the rental decline. According to Miki Shoji, the average class-A office vacancy in central Tokyo was 7.6% in September, with only a minimal increase since July. Bank financing has become more available at lower spreads, which should motivate potential buyers looking for yield-accretive purchases.

Through September this year, the sales rate of condominiums in the Tokyo Metropolitan Region stood at almost 70%, higher than 63% in the same period last year. In September, the number of unsold new condominium units declined to about 6,800 units, from 7,900 at the end of June, according to CEIC Data. Buyers have been enticed back into the market by easy access to bank financing and low interest rates, but more sustainable sales volume will depend on the depth of the economic recovery.

Asia Tigers

The IMF this month forecast a 2.4% decline in GDP in the sub-region (mainly consisting of Hong Kong, Singapore and South Korea) in 2009. Nonetheless, this is a significant improvement from the 5.6% contraction forecasted in April. Although the sub-region's economic risk is subsiding along with the global slowdown, the road to recovery is not without challenges. In fact, a protracted softening of external demand will weigh on the sub-region's growth, given their heavily export-reliant economies.

Demand for class-A office space in the sub-region remained selective in the quarter, although there were signs of stabilization in the financial sector and labor market. In Hong Kong and Seoul, where business sentiment was cautious and tenants adopted a wait-and-see stance in terms of expansions, the downward adjustments in rents continued, although the pace moderated in the third quarter. The sluggish leasing market will prompt landlords to offer more incentives and subsidies to retain tenants. In Singapore, the slow market is compounded by surplus supply this year and next. As a result, rents have declined by more than 10% each of the last two quarters. In the investment market, although the upward pressure on cap rates has subsided, the price mismatch between buyers and sellers has created a dearth of transactions.

The sub-region's residential market remained active in the third quarter, fueled by easier access to bank financing and low mortgage rates. In Singapore, the number of new residential units sold by developers in the first nine months of the year was 227% higher than the same period a year ago, and the full-year total is expected to exceed the record 14,800 units in 2007. According to the government's flash estimate, private residential prices climbed by 15.9% in 3Q09 after four consecutive quarters of declines. Meanwhile, developers are actively restocking their land banks through government land tenders, with prices above market expectations. The government in September announced measures to end some types of speculative activity, such as restricting payment schemes available to buyers and increasing residential land and housing supply.

Activity in the Hong Kong housing market remained brisk as well. According to the Hong Kong land registry, total residential sales and purchase agreements in Hong Kong rose by 82% in 3Q09 over 3Q08, while the total value increased by 139%. Wealth gained from the rising stock market and record low mortgage rates fueled the robust market. However, the central bank, concerned about the aggressive buying momentum, warned banks that low rates are not sustainable and may increase operating risks.

In Seoul, rising home prices prompted the Financial Supervisory Commission (FSC) to tighten mortgage lending in September. It also expanded the number of districts in metropolitan Seoul in which banks are subject to a rule that limits mortgages to a maximum debt-to-income ratio of 40% for borrowers. In July, the FSC lowered the ratio that home buyers can borrow using their property as collateral from 60% to 50%. Demand for residential mortgage loans is estimated to drop by 20-30% as a result. The Bank of Korea has also hinted at raising its policy rate, which has been 2% since February, should the residential market show signs of overheating.

The outlook for retail in the sub-region is more mixed. Retail sales in South Korea rose 1.8% in August from a year ago, while tourism grew by more than 10% year-over-year in July and August. A retail business survey by the Korea Chamber of Commerce & Industry found optimism at a two-year high. Prime retail rents in Seoul are therefore expected to remain firm. Consumer spending remained selective in Hong Kong and Singapore. Tourist arrivals in Hong Kong grew 5.8% year-over-year in August. In Singapore, the 0.7% year-over-year decline in August was the smallest drop so far in 2009. Retailers will likely offer more promotions and discounts to attract consumers, while putting any expansion plans on hold until economic conditions brighten up. Demand for prime retail space will be patchy as a result.

China and India

India's economy expanded by 6.1% in the second quarter, and the upward momentum continued in the third quarter. Indeed, India has been able to weather the global downturn because exports play a relatively small role in the economy. At the same time, the government's stimulus packages provide resources to boost domestic demand with tax cuts and increased spending on infrastructure and aid to rural areas. Low rainfall during the monsoon season between June and September will hamper crop outputs and cause food prices to increase. More than one-third of India's 625 administered districts have declared drought, according to the Ministry of Agriculture.

China's economy did well in August compared to 2008. Industrial production grew by 12.3%, retail sales climbed 15.4% and bank loans rose by 34.1%. Urban fixed-asset investments increased 33% year-to-date through August. That said, total exports in July and August fell 23% year-over-year, which signaled that the global trade environment has yet to rebound. Such recovery will be important for China to sustain its growth as exports account for almost 40% of its GDP. In the meantime, the government's RMB4 trillion pump-priming measures have boosted domestic investments and spending so far this year. The IMF expects China's 2009 annual growth to be 8.5%, only 50 bps lower than 2008. China's growing economic influence on Asia and the rest of world will likely deepen going forward, which will attract more foreign direct investments.

Year-over-year housing prices in China rose 1% in July, 2% in August and 2.8% in September, according to the National Development and Reform Commission. Market sentiment remained positive, supported by available credit and low interest rates. At the same time, developers have been active in banking more residential sites in the quarter. About 650 residential land parcels were reportedly sold in 60 cities in September, up slightly from August and more than double from a year ago. In an attempt to moderate the buying activity, the government increased the required down payment for second home purchases to 40% from 30% and first time home purchases to 30% from 20%. We believe that such measures will remove some speculative activity from the market. However, demand from genuine end-users will remain intact, on the back of the growing number of households in the middle class.

Class-A office rents in Beijing and Shanghai declined in the third quarter, but at a slower pace compared to the previous quarter, as vacancies showed signs of stabilizing. Despite this, the surplus supply situation continued to prompt landlords to be competitive on their rental expectations. Beginning this month, Chinese insurance companies will be allowed to invest in the domestic commercial property market. The growing number of RMB funds in China will also be another source of investment capital for the real estate investment market.

The retail space market in Beijing remained challenging in the third quarter, due to surplus supply. However, demand for retail space in Shanghai downtown areas remained relatively strong as retailers plan to expand to capitalize on the 2010 World Expo. Overall, the retail property market in China is supported by robust domestic consumption. Retail sales in China have been growing monthly by 15% year-over-year on average since the beginning of the year. With a population of 1.3 billion, China's private consumption potential is tremendous. Indeed, China's consumption rate of 37% of GDP lags far behind countries such as the U.S. (71%), the UK (67%) and Germany (54%), according to McKinsey Global Institute, indicating that there is a huge underlying spending power to be unlocked in the mainland.

Closing Thoughts

Strong public policies have significantly alleviated the fear of an economic meltdown and somewhat shored up the confidence of investors in Asia. The biggest challenge is perhaps how to sustain the growth when these government policies begin to wind down. It will be important for the private sector to step up with increased capital investment as government stimulus winds down. The transition from government-supported growth to a more substantive economy based on private sector volatility will be especially important in the office and retail sectors, where capital investment and consumer demand are the underlying demand drivers.

The region's class-A office rents declined in the third quarter, but at a slower pace compared to the preceding quarter, except in Singapore. Markets such as Beijing, Shanghai and Singapore are facing both surplus supply and below-trend absorption. In Seoul and Hong Kong, the rental decline in 3Q09 was much smaller than the previous quarter, which signaled that the downtrend is close to complete. In Tokyo, the current rental levels have become more attractive compared to the peak and we foresee more leasing interest going forward. In the retail sector, we believe that consumer confidence in Asia will strengthen when more economic indicators turn positive. Household spending will then expand to non-essential items, which will motivate retailers to explore their expansion plans again.

The recent downturn has challenged the conventional belief that real estate has a low correlation with other asset classes (stocks, bonds and commodities) and can serve to mitigate an investor's portfolio risk through diversification. Real estate's performance slipped in line with other asset classes during this crisis, as investors sold risky assets in favor of the safety of cash and government securities. Nonetheless, looking beyond a crisis, real estate investment should still be deemed as an important asset class for portfolio diversification purposes, not only in Asia, but globally.

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