Real Estate Analysis Report

Current Asian Property Markets ～Poised for Strong Growth～

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Introduction

Property markets in Asia and particularly in China have enhanced their global presence. For example, Asian markets occupied high positions in the 2009 global ranking by commercial property transaction value. Hong Kong and Seoul ranked fourth and fifth respectively following London, Tokyo and Paris, while Shanghai, Beijing and Singapore ranked seventh, twelfth and fourteenth respectively.[1]

In this paper, we define "Asia" as the region ranging from India on the western edge, to Australia and New Zealand on the eastern edge,[2] and not including Middle East or Central Asia. Furthermore, we define "Developed Asia" as the six countries of Australia, New Zealand, Japan, South Korea, Hong Kong[3] and Singapore. The other countries are regarded as "Emerging Asia."

1. Asian Property Market Features

① Strong Growth Expectations

Basically, property market growth is highly correlated with macroeconomic growth. For many years, Asian countries have enjoyed higher real GDP growth rates than any of the advanced countries, and have also been less affected by the recent financial crisis. They are expected to maintain a high growth pace for several more years (Chart 1).

A key factor for economic growth is population growth, especially of the productive population. According to a U.N. projection, productive population growth rates in Asian countries excluding Japan will be quite high over the next five years (Chart 2).

[1] Deutsche Bank Group RREEF, *Japan・Quarterly,* 1Q 2010. "Commercial property" does not include owner-occupied housing or land held for development.
[2] The region we define as "Asia" is generally called "Asia Pacific."
[3] Although Hong Kong is a special administrative region (SAR) of China, we treat it as a Developed Asian country.

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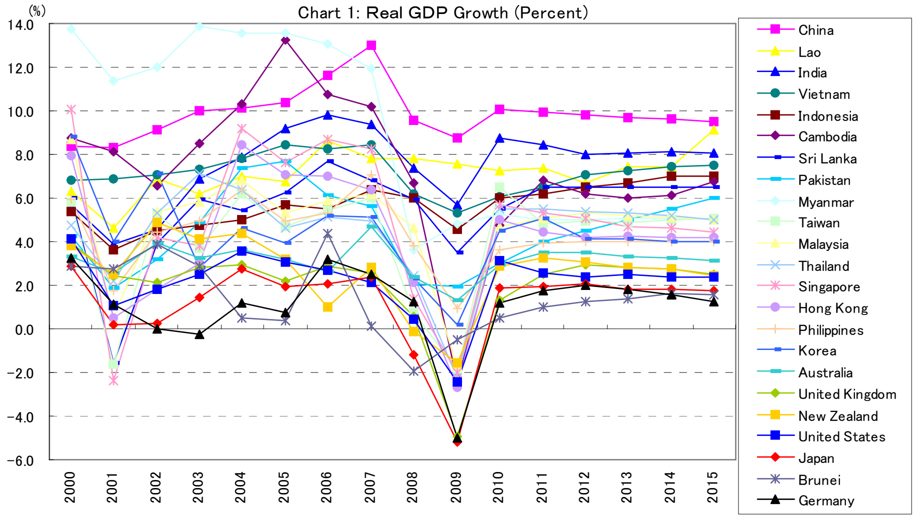
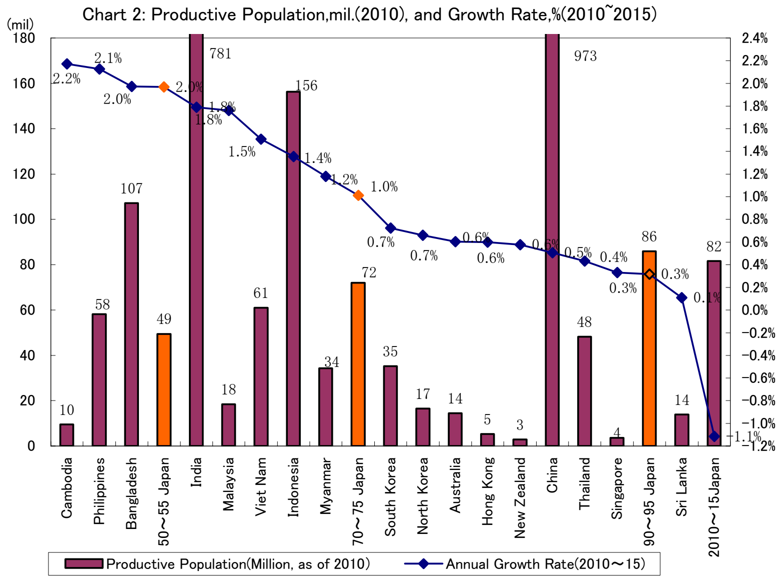
Chart 1: Real GDP Growth (Percent)



Source: IMF World Economic Outlook Databese, April 2010.

Chart 2: Productive Population,mil.(2010), and Growth Rate,%(2010~2015)



Source: United Nations

In addition to high population growth rates, Asian countries also have a population structure that is favorable to economic growth. These countries are now in the so-called demographic window, a period in which the under-15 and 65-and-over age segments comprise less than 30% and 15% of the total population respectively. This is considered ideal for long-term economic growth, because it implies a high level of national production and consumption and low social security burden (Chart 3).

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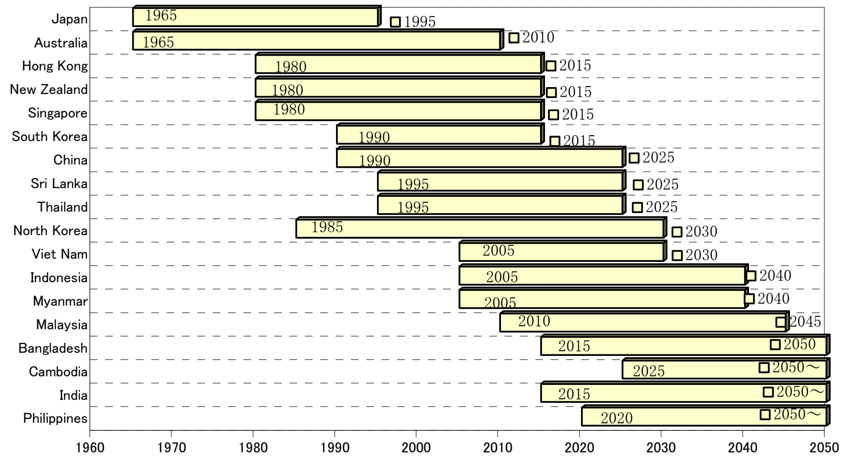
Chart 3: Demographic Window



Source United Nations

China, now one of the world's fastest growing economies, is in the midst of its demographic window. However, due to the one-child policy, China will likely experience an abridged demographic window and lower productive population growth rate compared to other Emerging Asian countries. In comparison, both the high population growth rates and demographic windows of other Emerging Asian countries are expected to continue long into the future.

On the other hand, China shares borders with many Asian countries and has a long record of cross-border trade dating back the historic "Silk Road" era. In recent years, China has strengthened cross-border economic ties by developing land and maritime transportation networks that connect southern China to Vietnam and Thailand, Southeast Asia, and India. These cross-border economic ties suggest that the demographic window of surrounding countries could potentially benefit China when its own demographic window eventually winds down.

Although Australia is now moving out of the demographic window, its active immigration policy is expected to help sustain the productive population growth rate. As a result, long-term economic growth prospects are favorable compared to Japan, whose demographic window has already shut down.

Another key barometer of property market growth is internal migration trends, especially the move into large cities known as "urbanization." Urbanization not only spurs national economic growth, but stimulates the growth of property markets because property is essential to business and daily life activities in cities.[4] According to a 10-year forecast by the U.N., Emerging Asia has ample room to boost its current low urbanization ratios, while Developed Asia has very limited room for additional urbanization (Chart 4).

[4] However, we must note that in countries with large inequalities of wealth and education, rapid urbanization can also have negative consequences by aggravating urban poverty (rise of slums) and pollution.

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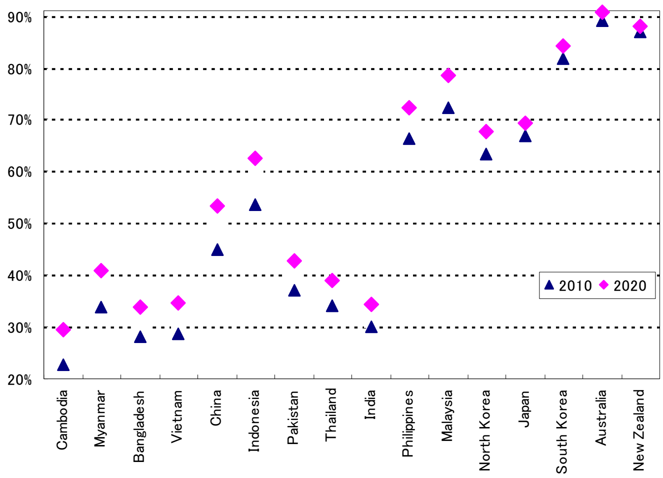
Chart: 4 Urbanization Ratio (Percent)



Note: Definitions of urbanization ratio vary. In Japan, it is the ratio of the total population living in densely inhabited districts (contiguous areas with population of 5,000+ and density of over 4,000 per ㎢).
Source: United Nations

② Market Maturity and Transparency

As seen above, while Asian property markets may have good growth prospects, having more room for growth in a sense also means that they are immature at present.

Many mega-cities exist both in Developed and Emerging Asia. According to U.N. data, the Asia Pacific region already has over 200 cities with a population of over one million, and accounts for more than 60% of the world's population. However, the region comprises only 30% of global GDP, and an even smaller share of the global property market.[5] Considering that more than half of Asia's property market is accounted for by Japan and Australia, Emerging Asia thus represents a very small part of the global property market.

Another measure of property market maturity is the size of the REIT market (Chart 5).

Chart 5: Asian REIT Markets

Market	No. of Funds	US$M	World Weight
Australia	70+	66,655	12.6%
Japan	38	31,908	6.1%
Singapore	21	20,555	3.9%
Hong Kong	7	9,872	1.9%
South Korea	3	134	0.0%
Malaysia	8	1,662	0.3%
Taiwan	12	1,770	0.3%

*Nearly half of Australian REITs invest in US properties.
*Nearly half of Singaporean REITs invest in other Asian properties.
Sourse: IREI,The Asian REIT Report 1Q 2010

The Australian REIT market is by far the biggest, reflecting its long history. And although Singapore's property market is relatively small, its REIT market is disproportionately large, reflecting a highly mature property finance market. On the other hand, while Japan's property

[5] 19% in 2007 by ING estimation, 29% in 2008 by DTZ estimation

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market is four times bigger than the Australian market, its REIT market is only half the size. As for Emerging Asia, most countries either do not have REIT markets yet, or else have very limited markets.

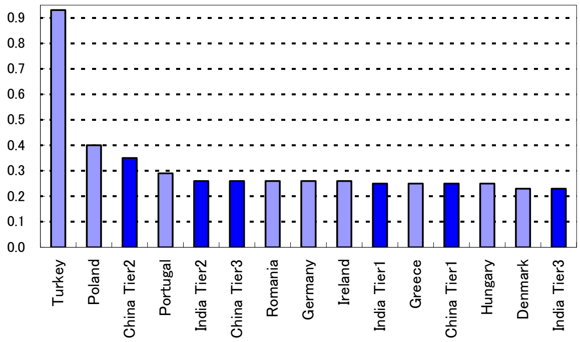
Regarding property market transparency, a useful measure is Jones Lang LaSalle's biennial "Global Real Estate Transparency Index," which integrates five factors—performance measurement, market fundamentals, regulatory and legal environment, listed vehicles, and transaction process (Chart 6).

Chart 6: Global Real Estate Transparency Index

Transarency Level	Rank	Market	Score
High	1	Australia	1.22
	2	Canada	1.23
	3	UK	1.24
	4	New Zealand	1.25
	5	Sweden	1.25
	6	USA	1.25
	7	Ireland	1.27
	8	France	1.28
	9	Netherlands	1.38
	10	Germany	1.38
	11	Belgium	1.46
	12	Denmark	1.5
Transparent	16	Singapore	1.55
	18	Hong Kong	1.55
	25	Malaysia	2.25
	26	Japan	2.39
Semi	33	Taiwan	3.07
	39	Thailand	3.15
	41	India Tier1	3.16
	42	South Korea	3.23
	44	Macau	3.33
	45	China Tier1	3.34
	48	Philippines	3.38
Low	49	India Tier2	3.51
	54	China Tier2	3.54
	55	India Tier3	3.65
	57	Indonesia	3.68
	65	China Tier3	3.97
	73	Pakistan	3.97
	76	Vietnam	4.29

Note: Shows only Asian countries from rank 16 downward.
Source: Jones Lang LaSalle、LaSalle Investment Management

Chart 7: Transparency Improvement (2008-2010)



Source: Jones Lang LaSalle、Lassale Investment Management

In Developed Asia, Australia and New Zealand have outstanding ranks that compare favorably even against European and North American countries. On the other hand, Japan and South Korea significantly lag behind other developed countries.[6]

As for Emerging Asia, market transparency levels are low in line with their maturity. But reflecting a global trend among low-transparency markets, significant improvements are occurring especially in China and India (Chart 7).

Considering the small market size relative to population, lack of REIT market development, and low market transparency, we can say that property markets in Emerging Asia are very immature at present. Thus we expect these property markets will not only grow in line with economic and demographic trends, but become increasingly mature.

[6] Unique market practices such as common-area service fees and ease of lease termination by tenants are often blamed for Japan's low ranking. However, every market has unique practices. Perhaps a better explanation is that since most market participants are Japanese, the low ranking reflects the perception of foreigners that access to market information in English is limited.

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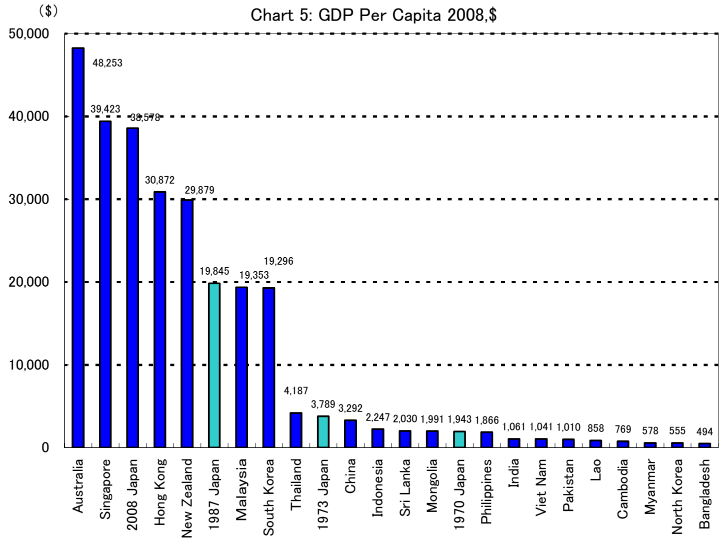
③ Diversity and Disparity

While Asian property markets are poised for strong growth, each market is unique. For example, in terms of land area, countries range in size from China and Australia to the city-states of Hong Kong and Singapore. Thus each property market needs to be treated differently.

In particular, large disparities exist in economic maturity between Developed Asia and Emerging Asia. Even in Emerging Asia, industrialization levels vary significantly from Thailand and Malaysia on the high end, to rapidly developing China, to late starters like Vietnam and India (Chart 5). In addition, large disparities also exist internally, such as between the coastal and inland areas of China. All of these economic disparities should be noted when looking at different property markets.

Chart 5: GDP Per Capita 2008,$



Source: United Nations

In addition, differences in industrial structure also significantly affect the diversity of property markets. In Developed Asia, for example, while each country has a major financial center, Hong Kong and Singapore, whose financial sectors are predominant, have very different property markets compared to resource-rich countries like Australia. Meanwhile, even within a country such as China, property markets can differ significantly between financial centers like Shanghai and other large industrial cities.

Furthermore, economic management policies are diverse in Asia. For example, while Australia and New Zealand have a western style of management, China is managed in a top-down style by the Communist Party. Meanwhile, Hong Kong and Singapore emphasize closer economic ties with China and neighboring countries, while remaining firmly tied to global financial markets. Indonesia and Malaysia are Moslem states and thus have different laws and customs from other countries. All of these characteristics are reflected in the respective property markets.

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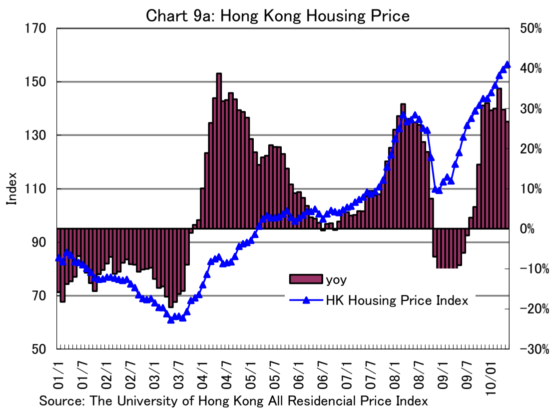
④ Asia' s Unique Position in the Global Economic Cycle

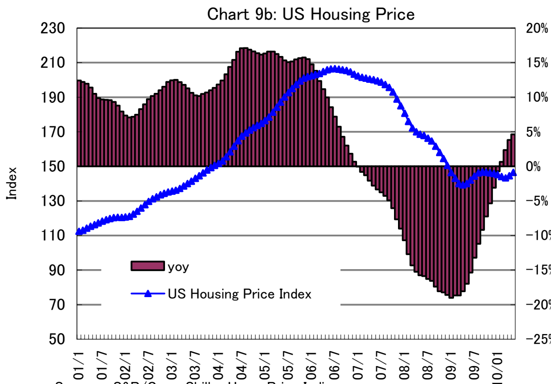
Due to the globalization of financial markets, when Lehman Brothers collapsed, the shock wave spread around the world almost instantaneously. At the time, even Asia's financial markets were unable to avoid a capital flight, with stock markets plunging and buyers disappearing from property markets. But the subsequent speed of recovery clearly outpaced other regions.

This can be explained by Asia's underdeveloped financial sector before the recession, and absence of debt-driven consumption that still plagues the U.S. and Europe. Thus when countries responded to the crisis with emergency fiscal and monetary measures, China and other Asian countries were among the first to see a direct effect on domestic consumption. As a result, their economies turned around sooner.

The stimulus package worked especially well for the housing market in China. Moreover partly because wealthy Chinese investors turned to opportunities abroad, housing markets in Hong Kong and neighboring countries also sharply turned around. In this respect, Asian markets have shown a distinctly different pattern from the West. For example, when the U.S. housing market plummeted after the sub-prime crisis, Hong Kong's housing market index continued to move upward, and rebounded from the Lehman shock so quickly that it is already well above the previous level (Chart 9).



Source: The University of Hong Kong All Residencial Price Index



Sounrce: S&P/Case-Shiller Home Price Indices

All major REIT indexes around the world tend to move together in close correlation with the global financial cycle. But as seen below, in the current recovery, the Singapore REIT index has risen more dramatically than others, marking a distinct pattern from that of Japan, Australia, and the U.S. (Chart 10).

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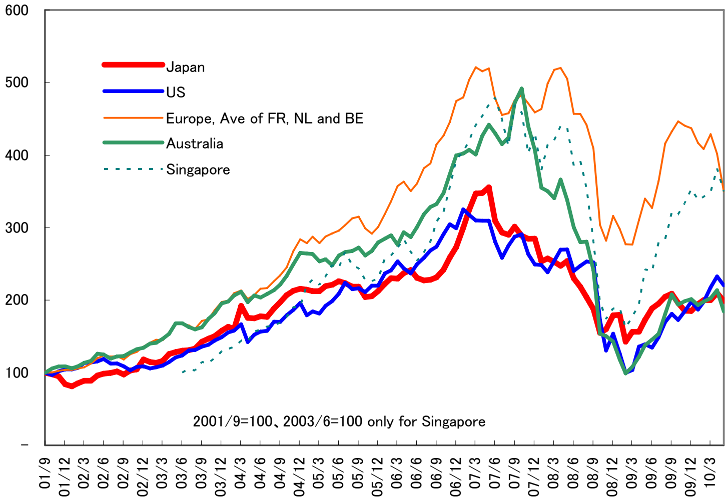
Chart 10: REIT Cumulative Return



Source: S&P REIT Index($)

2. Characteristics of Property Investment

① Focus on Housing Development in China

Several features of Asia's property markets emerge from watching the investment activities of Japanese property developers and global private funds. First, more Japanese property developers are entering China. Most of them are mainly engaged in condominium development or large retail-condominium complex development. The most common business model is to set up a local subsidiary or local joint venture, acquire land by auctions or through land grants from the local government, and construct and sell housing. Mori Building is an exception in that it has focused on office complex buildings in Dalian and Shanghai (Chart 11).

Chart 11: Major Japanese Players in Chinese and other Property Markets

Name	Category	Remarks
Mori Building Company Limited	Office complex development and investment	Owns three buildings in China: Shanghai Global Financial Center, HSBC Tower(Shanghai), Shin Mao Tower(Dalian)
Mitsui Fudosan Co., Ltd.	Condominium complex development	Entered China this year. Is now developing Tianjin Eco City and Ningbo Outlet Mall.
Mitsubishi Estate Company, Limited	Condominium complex development?	Established its Asia office in Singapore in Oct 2008. Has extensive experience in Europe and North America.
Daiwa House Industry Company, Limited	Condominium complex development	Has done many developments in China since 2006. Is now developing a major project in Dalian. Has plans to enter Viet Num and India
Sekisui House, Ltd.	Condominium development Housing development	Acquired a local developer in Australia. Operates in Thailand and China as well. Plans to enter Russia.
Marubeni Corporation	Condominium complex development	Pioneered in China about 30 years ago. Cooperates with Sumitomo Co. and Mitsui Fudosan. Operates in Vietnam, Philippines and Indonesia too.
Sumitomo Corporation	Condominium Complex Development	Cooperates with Marubeni Co. in China. Developed industrial parks in Asia nations.
Shinnihon Corporation	Condominium complex development	Developed Shen Yang station complex building Is developing high residences in the neighbor.
Sumitomo Forestry Co., Ltd.	Housing development	Operates in Australia and USA
ZECS Co., Ltd.	Senior housing development	Entered China this year.
ITOCHU Corporation	Industrial park development	Will develop infrastructure facilities of Dalian Industrial Park Development.

Source: NLI Research Institute

Similar to Japanese property developers, most global private real estate investment funds in

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Asia also focus on condominium developments. This is because in China and other Emerging Asian countries, housing demand has been very strong, limiting the risk of holding unsold inventories thus far.[7] Also, due to risks associated with legal and tax reforms in the future, investors prefer investment returns from the turnover of development projects rather than through the long-term holding and resale of rental properties.

This focus on housing development is a distinguishing feature of China's market compared to advanced countries, where investment is targeted at office buildings and other income producing properties. In Emerging Asia, investment activity is greatest in China, followed by India's stellar growth, while other markets are still small in size.

However, one cause for concern is the possibility of a property bubble in Shanghai and Beijing. The housing price level in large cities exceeds the amount that average people can afford.[8] Moreover, although the mortgage dependency ratio of banks is not currently high, a sudden price drop could trigger a surge of NPLs.[9] The government's tightening measures have led many observers to forecast a rapid housing price decline.[10] However, others argue that since the economy is excessively dependent on the property market, the government will likely do whatever is necessary to avoid a housing market meltdown.[11]

② Significance of Industrial Property

Next to housing development, another prominent type of investment in Emerging Asia is industrial property developments such as public infrastructure and industrial facilities. As seen by China's role as the world's factory, Emerging Asia has huge manufacturing and logistics facilities, and the demand for industrial property continues to expand with the growth of exports and domestic consumption. Moreover, large cities face serious problems such as electric power shortages and chronic traffic congestion, and are in urgent need of building more sophisticated infrastructure facilities.

Whereas housing development is a relatively clear-cut process consisting of land acquisition, construction and sales, industrial property development tends to be more complicated for investors, including the case of large government-led projects. The risk profile can change significantly depending on whether the aim is to exit profitably after development, or hold income producing properties for many years after development. Moreover, long-term investments can have totally different cash flow characteristics depending on such factors as

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[7] In major Chinese cities, the large inflow of people has caused serious housing shortages. The government is supplying inexpensive public housing on a large scale, but not enough to ease the problem.

[8] According to data from Beijing Municipal Statistical Bureau, the housing unit price reached 27times the annual income of workers.

[9] According to Xinhua News Agency, this year the government instructed banks to perform a stress test consisting of a 30% housing price decline and 108bp rise in interest rate. Results were within expectations, with mortgage loan NPLs increasing 2.2% and banking sector profit shrinking 20%. And the next stress test may assume a 50% housing price decline.

[10] After regulations were tightened in April, housing unit sales plunged. There have been reports of a recovery in sales volume reflecting price discounts. According to Jones Lang Lassale, the premium housing price in Shanghai continued to post a quarterly gain in Q2.

[11] Although the banking sector's dependence on mortgage loans is not high, a significant part of GDP growth is structurally dependent on property developments. For example, local governments rely heavily on land sales as a source of income, while many manufacturers need property related income to offset weak profit margins, and then.

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type of tenant and specific contract terms.[12]

③ Immaturity of Office Market

In contrast to housing and industrial property developments, investment in income-producing office buildings, which is most common in global developed markets, is still quite minor. Although some Asian funds focus on office buildings, they are mostly limited to Developed Asian markets like Japan or Australia.

This can be attributed in part to the immature condition of office markets in Emerging Asia. Office demand tends to emerge in big cities as the economy matures and the service industry becomes prominent. Thus in Developed Asian countries such as Japan and Australia, the office market is already a primary target of investors. But in Emerging Asia, the large population migration into cities continues to generate urgent needs for housing and industrial property development, making these the main focus of investors. Although office markets are seen in huge cities like Shanghai and Beijing, investment opportunities in office buildings are still limited in Emerging Asia.[13]

As seen by the discussion to introduce a C-REIT market in China, investment opportunities in stable income-producing office properties are expected to increase as economies grow in Emerging Asia.[14]

A Final Note

Given the poor prospects of long-term growth for real estate investment in advanced countries, investors seeking global diversification are turning to Asian property markets to tap the strong growth potential of China and the rest of Asia.

Generally speaking, property investment in overseas markets involves many difficulties such as the high cost of field research and local office maintenance, differences in transaction and leasing practices, and differences in local building quality standards. On top of these, Emerging Asian markets can pose significant country risks and risks associated with local policies, regulations, and legal and taxation systems, as seen by the requirement in China for foreign investors to establish local subsidiaries or collaborate with local companies. Moreover, even if compliance can be achieved today, there is the risk of change in the future such as stricter foreign money transfer regulations or new tax rules. Thus foreign investors must face a heavy burden when managing local operations in each country.

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[12] For example, a Singaporean trust which owns water supply facilities has a stable and guaranteed income from the government, while other funds that invest in toll roads or ports have a volatile income based on traffic or transport frequencies.

[13] Recently, many high-rise office buildings have been completed in China, but the number of Grade A buildings by global standards is still limited. Most are owned by domestic developers, the government and other parties, with limited foreign ownership consisting mainly of Hong Kong developers. Hong Kong tier 1 players such as Sun Hung Kai, Kerry, Hung Lung, and Henderson Land have all developed and continue to own office and retail mall properties on the mainland. Capita Land of Singapore also owns many retail malls as well. From Japan, the only player is Mori Building, which owns three office buildings including Shanghai Global Financial Centre.

[14] Limited cases already exist, such as Capita Retail China Trust listed in Singapore, which owns retail malls in China, and GZI REIT listed in Hong Kong, which owns offices and retail malls in Guang Dong.

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Considering these risks, it makes sense to diversify investment across countries rather than to concentrate on a single country. Market diversification can be achieved by blending Emerging Asia and Developed Asia for a balanced portfolio of growth and stability. This would also achieve diversification of property types due to the housing development focus of Emerging Asia and office property focus of Developed Asia.

In any case, global investors can no longer ignore Asian property markets when constructing long-term diversified global portfolios.

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