Alpha Watch

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Asia Pacific Real Estate Securities

Opportunities still abound

Contents

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Executive summary

The Asia Pacific (APAC) real estate securities market has outperformed the broader equities market in the last five years amidst a low interest-rate environment sustained by global liquidity flows. Going forward, there are concerns that an expected interest rate hike by the US sometime in 2015 will lead to higher borrowing costs, lower property valuations and yield spreads for real estate securities. Notwithstanding, we think the APAC real estate securities market will continue to remain attractive for various reasons:

- **Shift in global economic activity towards Asia and increased urbanization led by India and China will spur demand for real estate.** The direct real estate market in APAC is expected to more than double in size in 2021, which will lead to an increase in the number of properties that can be securitised.

- **Further development of Real Estate Investment Trust (REIT) regimes in the region such as in India and China will boost growth in the APAC real estate securities market.**

- **The impact of an interest rate hike on real estate securities may have been overstated.** The performance of real estate securities is more sensitive to economic growth than changes in interest rates. APAC REITs have also mitigated the risk of an interest rate hike by reining in their debt exposure and extending loan tenures to reduce refinancing risk.

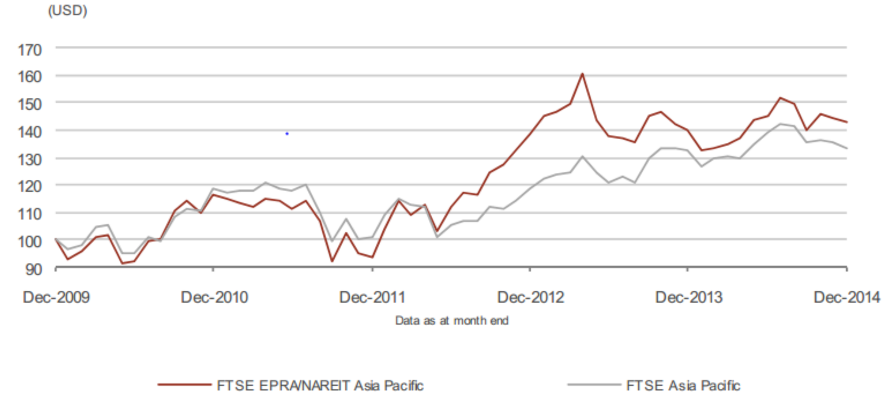
As part of a real estate portfolio, real estate securities can complement investments in real estate funds. Real estate securities can be easily traded with no fixed investment terms while private real estate funds typically have a fixed fund life. Real estate securities offer access to non-traditional and specialised assets, while property funds are typically focused on traditional assets. The higher frequency of the payouts for real estate securities is also a complement to the more lumpy payouts from property funds based on the cycle of property acquisitions and divestments.

We therefore view investment in real estate securities favourably. However, as the performance of the direct real estate market varies across countries and sectors, stock selection and access to local market knowledge are important to extract the best value from investing in real estate securities. For 2015, we are positive on Japanese listed real estate securities, especially on developers and Japan REITs with exposure to the office and residential markets as well as major Hong Kong-listed Chinese developers.

Introduction

Amidst the low interest-rate environment sustained by global flows of liquidity, the APAC real estate securities market outperformed the overall APAC equities market in the last five years[1]. The total return of APAC real estate securities averaged 7.4% per annum in the last five years, compared to 5.9% for the broader APAC equities market (Figure 1).

Figure 1: Five-year performance of APAC real estate securities vis-a-vis APAC equities – total return



Source: FTSE Factsheet, Dec 2014

In individual markets, real estate securities have also consistently outperformed the local equities markets (Figure 2).

Figure 2: Annualised total returns of real estate securities versus equities market in selected APAC markets (2012-2014)

Country	Real estate securities*	Equities
Japan	36.3%	26.5%
Australia	21.1%	13.7%
Singapore	13.7%	8.4%
Hong Kong	9.7%	9.2%

Source: Bloomberg, AIP Research
Data is based on annualised 3-year total returns between 2012 and 2014. *Japan: data is based on the TOPIX Index and TOPIX Real Estate Index. Australia: data is based on S&P/ASX 200 Index and S&P/ASX 200 Real Estate Index. Singapore: data is based on FTSE ST Real Estate Index and the Straits Times Index. Hong Kong: data is based on the Hang Seng Index and Hang Seng Properties Index. Data is calculated in local currency.

Going forward, however, there are concerns that an interest rate hike by the US sometime in mid-2015 will lead to more volatility in the share prices of real estate securities. An interest rate hike implies higher borrowing costs and a higher discount rate to be used in asset valuations, which could lower the valuations of physical properties owned by listed REITs and developers. An

[1] Based on the FTSE EPRA/NAREIT Asia Pacific Index.

interest rate hike also reduces the yield spread, making real estate securities less attractive as an investment. Notwithstanding these concerns, we think there are other factors that will continue to contribute to the attractiveness of the APAC real estate securities market.

Economic growth and urbanization to drive real estate market in APAC

The APAC real estate market will grow in global importance in tandem with the shift in global economic activity from developed countries such as US and Europe to Asia. The share of US and European countries in global GDP is projected to fall from 67% in 2000 to 57% by 2019 while APAC's share of global GDP is projected to increase from 23% in 2000 to 31% in 2019[2]. This shift in global economic activity towards APAC is driven by demographics, with Asia currently home to more than 60% of the world's population.

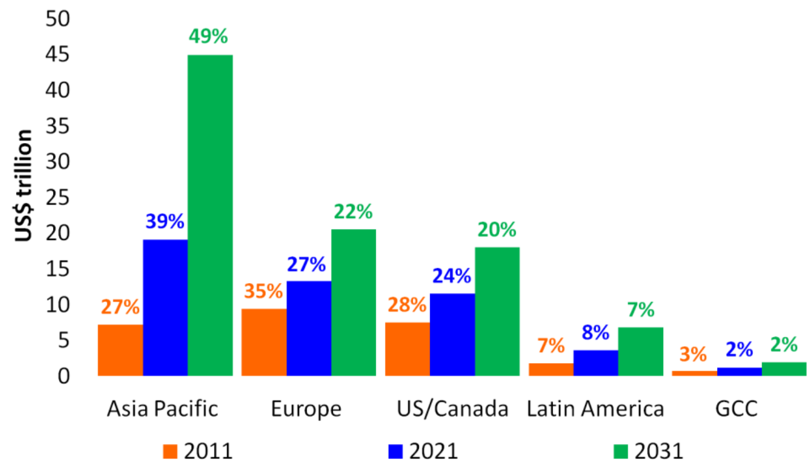
As the population moves into cities in search of jobs, the trend of urbanization will also support the growth of the real estate market. According to the United Nations, the largest growth in urban populations globally between 2014 and 2050 will be led by India and China. By 2050, India and China are projected to add 404 million and 292 million urban dwellers respectively.

Greater economic activity and increased urbanization leading to rising levels of wealth will spur demand for real estate such as apartments, offices, malls and hotels. The physical real estate market in APAC is projected to more than double from US$7.2 trillion in 2011 to US$19.1 trillion in 2021 and will increase further to an estimated US$44.9 trillion by 2031[3], overtaking the US and Europe (Figure 3). This growth will lead to an increase in properties that can be securitised.

Hong Kong, China, Japan and Singapore are currently amongst the top five largest listed real estate markets[4] globally, but their combined market capitalisation is only slightly bigger than the largest single market of the US, implying that there is further room for growth in the APAC real estate securities market (Figure 4).

[2] Source: EIU. Based on GDP at constant market prices (US$).
[3] APREA, The Significance of the Asia-Pacific Real Estate Markets, June 2013.
[4] Includes both listed REITs and listed developers.

Figure 3: Size and % share of global physical real estate markets: 2011-2031 (US$ trillion)



Source: APREA, AIP Research

Figure 4: Top five real estate securities markets globally

Market	Market capitalisation (US$ bn)	% share of the global listed real estate market
US	997.4	33.8%
Hong Kong	380.4	12.9%
China	309.0	10.5%
Japan	213.3	7.2%
Singapore	110.0	3.5%
Total for Hong Kong, China, Japan and Singapore	**1,012.7**	**34.4%**

Source: Bloomberg, 15 Jan 2015, AIP Research

New REIT regimes to boost growth of APAC real estate securities market

Although the REIT markets have been established in Asia over the last 15 years, namely in Japan, Singapore, Hong Kong, Malaysia, Taiwan and South Korea, there are still markets where REIT regimes are still in the infancy stage or are yet to be launched, where if established, will add on to the size of the real estate securities market in APAC.

China took baby steps in developing its own REIT regime when Citic Securities launched the Citic Qihang Specific Asset Management Plan in April 2014. This was however not publicly listed and sold only to institutional investors. Notwithstanding, some managers have started to offer real estate funds with the view to converting them to publicly-listed REITs when regulations allow. China reportedly may allow REITs in 1H2015, with initial trials in four cities, namely Beijing, Shanghai, Guangzhou and Shenzhen. Property assets that can be spun off into publicly-listed REITs could top US$6.0 trillion by 2020[5]. An attractive REIT regime is expected eventually given the government's desire to liberalise the financial services sector and grow the services sector.

The Securities and Exchange Board of **India** (SEBI) approved REIT regulations in September 2014. Although it is not clear yet when the first Indian REIT will be listed, JLL estimates that of the 370 million sq ft of Grade A office stock in India, 170 million sq ft is of REIT standards. Assets that may qualify to be included in REITs could reach US$20.0 billion by 2020[6].

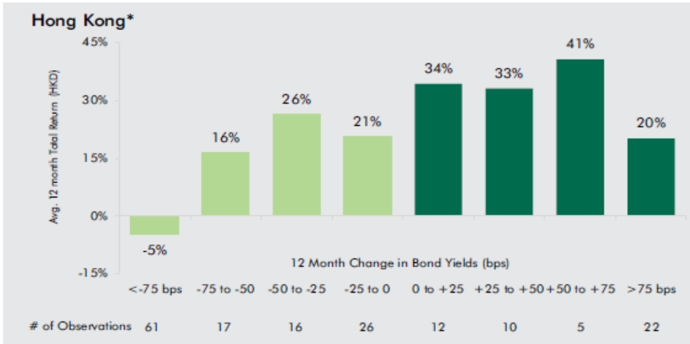
Thailand saw its first REIT listed in October 2014. Its US$488.0 million IMPACT Growth REIT was the largest initial public offering in Asia outside Japan at that time[7]. Meanwhile, **Malaysia** was one of the earliest REIT markets in Asia but it is still relatively small and considered an untapped market. Growth is expected to continue going forward, especially since Malaysia dominates the market for Shariah-compliant REITs, given its position as a hub for Islamic finance.

Real estate securities more sensitive to economic growth than interest rates

Historically, the performance of REITs has demonstrated minimal sensitivity to changes in interest rates. If central banks are confident enough about the outlook for economic growth and inflation to raise interest rates, this implies improving economic conditions. The improvement in economic conditions will boost tenant demand, revenue and returns for owners and operators of commercial properties. During periods of faster economic growth, rental growth prospects have outweighed higher financing costs and REITs' returns have increased even as bond yields rose. For instance, double-digit returns were registered for Japan and Hong Kong REITs (Figures 5-6) when yields were rising while there is no clear-cut inverse relationship between the 10-year bond yields and the share price performance of REITs in Singapore and Australia (Figures 7-8). REITs have also produced positive total returns most of the time when the economy is growing (Figures 9-10).

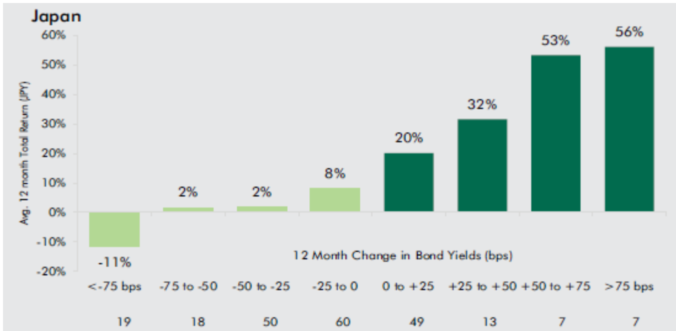
[5] South China Morning Post, China REITs could top US$6 trillion, 17 Nov 2014.
[6] Cushman & Wakefield.
[7] Nikkei Asian Review, REITs expand reach in Asia, 25 Sept 2014.

Figure 5: Hong Kong REIT performance during periods of rising bond yields



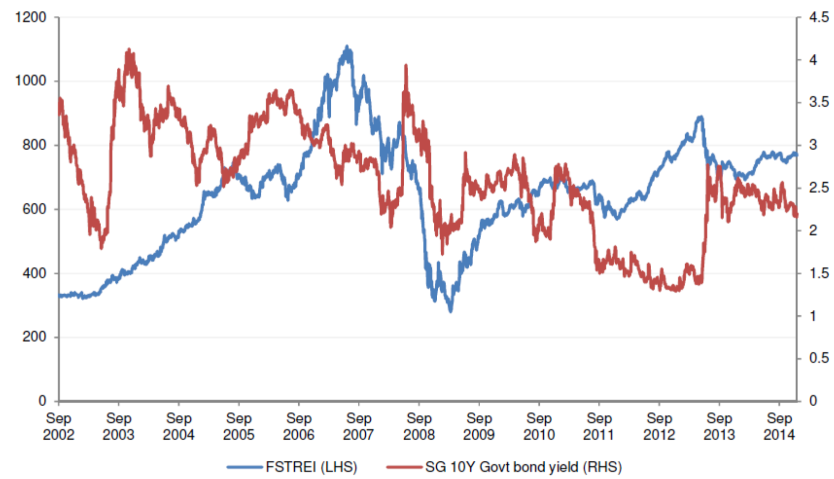
Source: Bloomberg and CBRE Clarion
***Data is from Jun 1999 – Jun 2014 (169 twelve month observations). Data is based on FTSE EPRA/NAREIT Hong Kong Index and Hong Kong Generic 10 Year Yield Index.**

Figure 6: Japan REIT performance during periods of rising bond yields



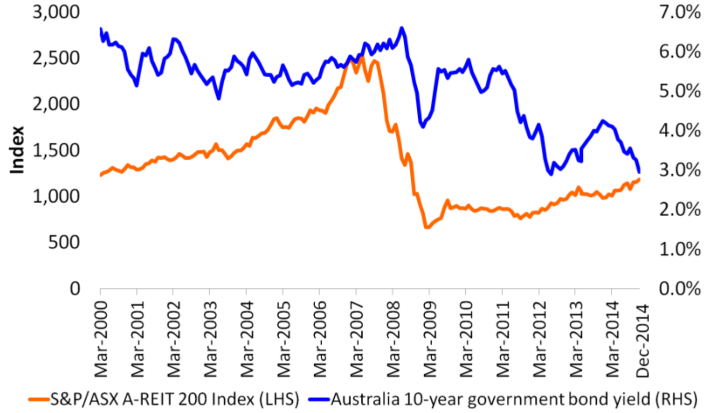
Source: Bloomberg and CBRE Clarion
***Data is from Dec 1994 – Jun 2014 (223 twelve month observations). Data is based on FTSE EPRA/NAREIT Japan Index and Japan Govt. Bond Year to Maturity 10-Year Simple Yield.**

Figure 7: Singapore Government 10-year bond yield versus FTSE ST REIT Index



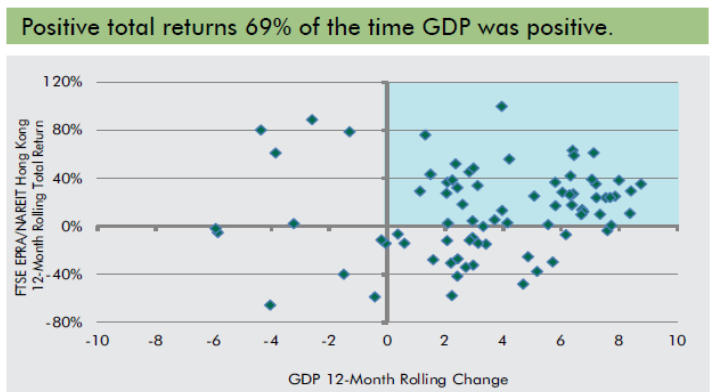
Source: Bloomberg, OIR

Figure 8: Australia Government 10-year bond yield versus S&P/ASX A-REIT 200 Index



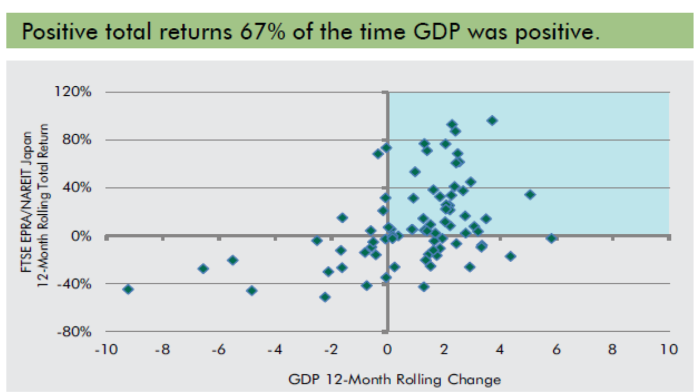
Source: Bloomberg, Reserve Bank of Australia, AIP Research

Figure 9: Hong Kong property stocks versus GDP performance



Source: CBRE Clarion, Bloomberg and Factset
***Data is from 30 Sep 1994 – 30 Jun 2014 and based on FTSE EPRA/NAREIT Hong Kong Index.**

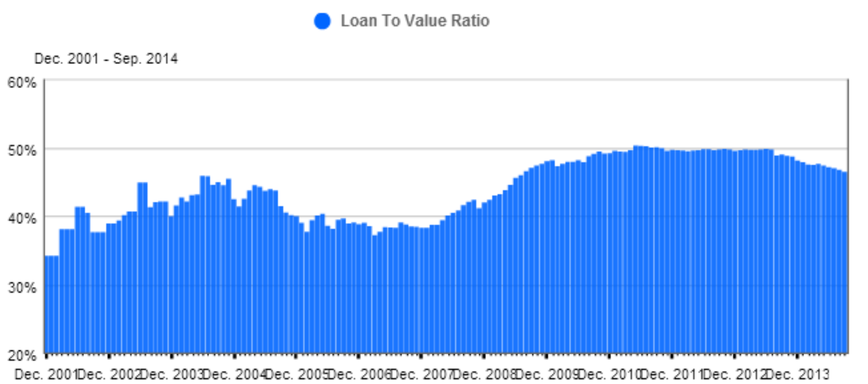
Figure 10: Japan property stocks versus GDP performance



Source: CBRE Clarion, Bloomberg and Factset
***Data is from 30 Sep 1994 – 30 Jun 2014 and based on FTSE EPRA/NAREIT Japan Index.**

Going forward, APAC REITs have mitigated the risk from an interest rate hike by reining in their debt exposure and extended loan tenures to reduce refinancing risk. For example, an average 75.2% of the debt of Singapore REITs is on fixed rates or has been hedged via interest rate swaps[8]. In Australia, A-REITs have also looked to diversify their sources of debt and increase maturities. Median gearing increased slightly from 29% to 32.6% in 2014, but this was largely a result of the attractive debt and capital markets for A-REITs, as managers were able to replace expensive debt with lower interest rates[9]. The loan-to-value of J-REITs has also been on a downtrend since the beginning of 2014 (Figure 11).

Figure 11: Loan-to-value ratio for listed J-REITs



Source: Prepared by ARES from published data

Standard and Poor's[10] also expects that APAC REITs can largely bear the higher interest burden and rated the APAC REIT industry with a stable outlook in November 2014. Coupled with the positive economic growth expected in the APAC economies going forward, the risks of an interest rate hike on the REIT market may have been overstated (Figure 12).

Figure 12: GDP growth forecasts for selected APAC economies

Country	GDP growth (2014)	GDP growth forecast (2015-2019)
China	7.4%	6.3 – 7.1%
Hong Kong	2.3%	3.3 – 3.8%
Australia	2.5%	2.9 – 3.0%
Singapore	2.9%	3.0 – 3.1%
Japan	0.0%	0.8 – 1.0%

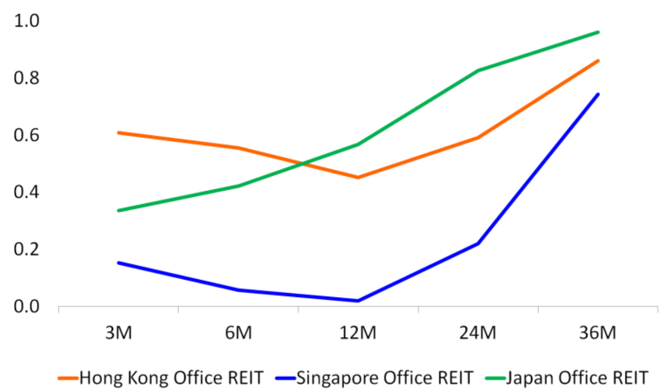
Source: National statistics offices, Bloomberg, IMF, AIP Research

[8] OCBC Investment Research
[9] BDO, A-REIT 2014 survey.
[10] Standard & Poor's, Asia-Pacific REITs rein in debt costs amid a likely hike in interest rates, Nov 2014.

Real estate securities complement real estate funds

The benefits of investing in real estate securities have been well espoused. They offer investors a combination of income-producing investment opportunities (from the REITs) and development opportunities (from listed real estate developers). Real estate securities offer exposure to the direct real estate markets while offering the liquidity of the stock market. In particular, returns performance in real estate securities demonstrate a high correlation to that of direct real estate in the medium to long-term. Our study on the returns from REITs against the returns from investing in direct real estate in the same sector shows that while the correlation with the direct market was low in the short term, there was a strong correlation between REIT and direct real estate performance over the medium and long term (Figure 13). Investments in REITs are therefore a good proxy to investing in the direct market for investors with a three-year or longer investment horizon.

Figure 13: Correlation with direct real estate based on holding period



Source: Bloomberg, JLL, Factset, AIP Research

***Based on comparing returns from Japan office REIT versus Tokyo office sector; Singapore office REIT versus Singapore office sector and Hong Kong office REIT versus Hong Kong office sector.**

As part of a real estate portfolio, the attributes of real estate securities can complement investments in real estate funds. Real estate funds typically have a fixed fund life while real estate securities can be easily traded and there is no fixed term to investing in real estate securities.

Real estate securities can offer access to non-traditional and specialised assets such as hospitals, nursing homes and retirement homes, while most property funds are typically focused on traditional assets.

The higher frequency of the payouts for real estate securities is also a complement to the more lumpy payouts from property funds based on the cycle of property acquisitions and divestments.

Market expertise key to identifying opportunities

As performance of the APAC physical real estate markets varies across countries and sectors, stock selection is important, especially against the backdrop of an expected interest rate hike. For instance, real estate securities generally provide a premium over local bond yields (Figure 14). REITs, in particular, tend to be high dividend-yielding securities. However, this premium varies across securities, with some securities offering dividend yields that are lower than local bond yields.

Figure 14: Dividend yields versus bond yields in major APAC markets

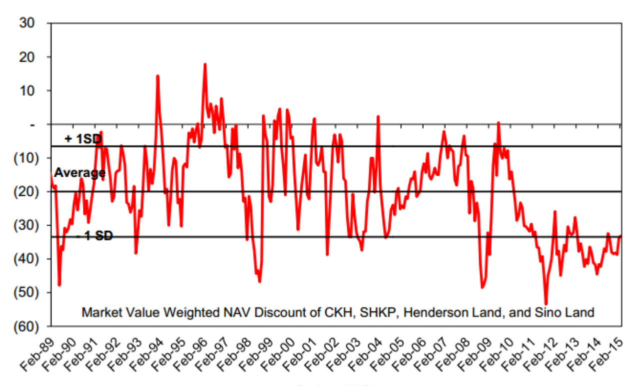
Country	Securities dividend yields*	10-year bond yields	Yield premium	Individual security dividend yields (2014)
Australia	4.04%	2.56%	1.48%	0.64 – 11.11%
Hong Kong	3.79%	1.47%	2.32%	0.27 – 11.49%
Singapore	3.76%	1.87%	1.89%	0.26 – 11.58%
Japan	0.78%	0.26%	0.52%	0.10 – 7.15%

Source: Bloomberg, 28 Jan 2015, AIP Research

***Australia: dividend yield data is based on S&P/ASX 200 Real Estate Index. Hong Kong: data is based on the Hang Seng Properties Index. Singapore: data is based on FTSE ST Real Estate Index. Japan: data is based on TOPIX Real Estate Index.**

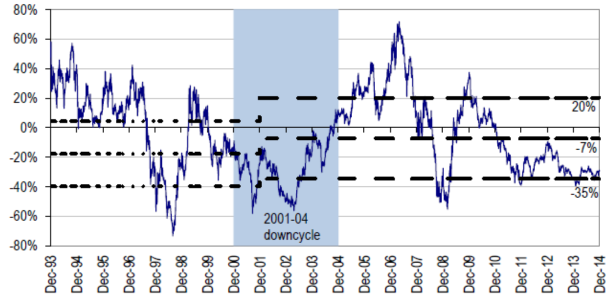
Access to real estate expertise is also important to identify potential investment opportunities from undervalued stocks. Although listed developer stocks generally have lower dividend yields than REITs, some could provide a good investment opportunity as they are currently trading at a discount. For instance, Hong Kong developers are trading at more than 30% discount to net asset value (NAV) while Singapore developers are trading at about 35% discount to NAV (Figures 15-16).

Figure 15: Hong Kong developers – NAV discount



Source: Company; Citi Research

Figure 16: Singapore developers – price to NAV



Source: Datastream, Citi Research

2015 outlook

Most major Asian economies are expected to continue to grow moderately in 2015, supported by accommodative fiscal and monetary policies and the fall in oil prices with most being net oil importers. Notwithstanding, there could be some downside surprises including a faster-than-expected interest rate hike in the US, rapid appreciation of the USD resulting in sharp tightening of the global funding situation or a further fall in oil and commodities prices leading to a deflationary cycle.

In the physical property market, there continues to be some bright spots. Office rental growth is supported by healthy leasing activity and limited supply in most major cities including Tokyo, Hong Kong and Singapore, although rental growth in Singapore could slow in 2H2015 due to the supply spike in 2016/2017. Urbanization and increasing consumerism remain supportive of the retail sector even as labour constraints and occupancy cost issues continue to pose challenges. The growth of e-commerce will benefit the logistics sector, especially in China and Japan. Sentiment in most residential markets in the region other than Japan and China is expected to remain subdued amid continuing cooling measures but there could be some improvement in China from the relaxation of home purchase restrictions and the loosening of mortgage rates.

The listed developers in the region are generally not expensive from the valuation perspective. Japanese developers are trading at about 15% discount to their RNAVs, while developers in Hong Kong, China and Singapore are at above 30% discount. For 2015, we remain positive on Japanese listed real estate securities, especially developers and J-REITs with exposure to the office and residential sectors. The fundamentals are healthy with strong demand for housing and declining vacancies and accelerating rental growth for offices while valuations are not overstretched. We also like major Hong Kong-listed Chinese developers who will benefit from the bottoming out of the transaction volume and housing prices in selected cities. We see potential in developers and REITs with exposure to the office sector in Hong Kong and Singapore and to the logistics sector in China and Japan.

Alpha Investment Partners

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Equipped with a strong business network, our team of professionals aims to achieve superior investment performance by capitalizing on our unique insights into the region's property markets offering investors the competitive advantage akin to a local player. In addition to the expertise we possess in the area of investment, we establish the highest standards of corporate governance, reporting and compliance to meet investors' expectations. We strive to integrate sustainability practices into our invested assets. Our corporate culture is shaped by empowerment and trust.

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