

TECHNICAL PAPER

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“All Change” in Investor Strategy Towards Asia Pacific Property Markets

- ▶ Asia Pacific’s (APAC) property market offers overseas investors wide ranging investment opportunities underpinned by urbanisation and rapidly rising incomes.
- ▶ High-income economies of APAC provide a low risk means to access the region’s growth which is home to three of the world’s four most populous nations, all of which are growing strongly.
- ▶ To allocate capital to the region we favor strategies that focus on key long-term themes of population growth in high-income countries, the expansion of the middle classes in APAC’s emerging markets, and aging demographics.

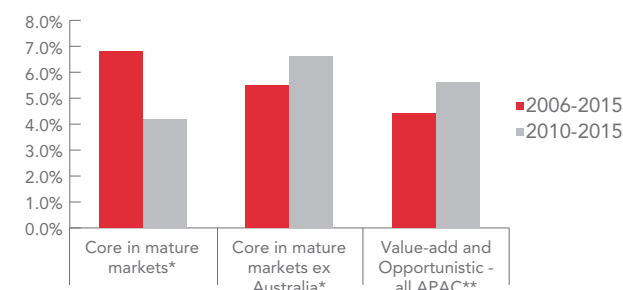
APAC is home to three of the world’s four most populous nations (China, India and Indonesia) and growing rapidly. Prior to the global financial crisis offshore investors mostly pursued high risk property investments to capture the tremendous growth of the region. However, many investors achieved disappointing returns due to an underestimation of property investing risk within Asia’s emerging markets. However, we see a structural decline in investing risk within APAC’s high-income economies which is attracting low-risk overseas investors to the region; they are allocating capital to diversify as well as to potentially achieve higher returns than are available in their home market.

This paper outlines Asia Pacific’s investment landscape in terms of its historic return performance, its risk characteristics, and the size of the institutional property universe. We believe APAC’s high-income markets are a low risk means of accessing the growth of its emerging markets, as they urbanise and experience a catch-up in incomes with the industrialised west.

A change in investment strategy

Prior to the global financial crisis many investors pursued high-risk strategies in the region. However, over the past five and nine years APAC’s lower-risk core property has outperformed more risky strategies (value-add and opportunistic investments across APAC including its emerging markets) by approximately 100 basis points (see chart 1), the opposite of what investors are likely to have anticipated. This result holds even after excluding Australia which has a high weighting in ANREV’s core funds’ performance indices. Increasingly overseas investors are considering low risk property allocations in APAC to diversify their domestic property holdings, and no longer just see the Asia Pacific region as just a source of high potential returns.

Chart 1: APAC property fund returns in US dollars



* Mature markets include Australia, Japan, Hong Kong, Singapore and Korea. Returns based upon a core investment style in single country funds or on a pan-Asia pacific basis.

** Value-add and Opportunistic returns include the whole of Asia Pacific.

Source: ANREV based upon calculations made by Aberdeen Asset Management.

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A look at the annual ANREV investment intentions survey illustrates a shift in how investors view the Asia Pacific property markets. Prior to the global financial crisis, overseas investors indicated a focus to the region's emerging markets, accounting for the top six markets out of ten identified by investors (see chart 2). Almost a decade later, by 2016, only one of the top ten strategies cited by investors was within Asia's emerging markets. The inclusion of China's first tier office markets, which have expanded tremendously in scale over the past decade, probably reflects a view that it is relatively low risk because of the increasing investment depth of the market.

Note that the ANREV survey question on the preferred destination has changed from a country/sector basis in 2008 to city/sector for the 2016 survey. Nonetheless, we still believe that the results broadly capture the shift in investor strategy in the region. The question investors need to ask is whether such a shift is just a one-off or represents a step change in the approach of investors in the Asia Pacific region?

Chart 2: Preferred investment destination of investors, ANREV Investment Intentions Survey

2008	2016
Japan offices	Tokyo Offices
China residential	China 1st tier offices
India residential	Sydney Offices
Vietnam residential	Melbourne Offices
China Retail	Tokyo Logistics
China Diversified	Hong Kong Offices
Singapore Offices	Sydney Logistics
Japan Logistics	Sydney Retail
India Diversified	Tokyo Residential
South Korea Offices	Osaka Offices

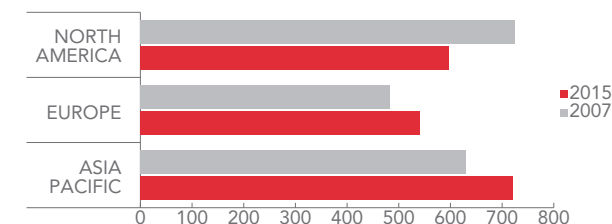
Emerging market – red
Mature market – grey

Source: ANREV Investment Intentions Survey (2008 and 2016).

De-risking of Asia Pacific property

Although historically APAC's property markets have been viewed as under-developed and high risk, investors increasingly see the market de-risking top-down and bottom-up. Bottom-up there are significantly more large listed corporates headquartered in Asia Pacific today than in North America (see chart 3). The rise of large APAC corporates indicates a rising pool of financially strong property occupiers, and a corresponding need for high quality commercial property space. Given Asia Pacific's relatively strong economic growth trend we expect the rise of large corporate occupiers to be sustained going forward.

Chart 3: APAC over takes North America in large company rankings



Source: Forbes 'Global 2000' ranking of largest listed companies; determined by turnover, profits, assets and stockmarket capitalisation. Figures do not sum to 2000 as some regions are not shown.

We also see de-risking top down as local pools of investment capital increase sharply. Accumulation of wealth in Asia's emerging economies should lead to the institutionalisation of investment capital, and rising allocations to low risk properties globally. Due to strong intra-regional trade/investment ties and geographic closeness, a bias in allocations to APAC markets is likely, and particularly towards its high-income countries.

We see the growth of pension and insurance industries as key drivers of local institutional capital flows into property – and the scope for growth is considerable as incomes climb in Asia's emerging markets. Rising wealth should also encourage the further development of listed property vehicles (including Real Estate Investment Trusts or REITs), creating better property market depth and liquidity; the listed property sector in high-income APAC countries is already two-thirds larger than that of Europe. We see rising participation of listed property companies, pension and life insurance funds in the APAC property market as lowering investment exit risks for overseas investors over the medium and long term.

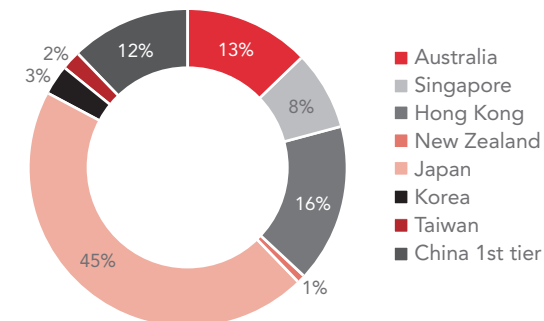
The size of the APAC institutional property market

APAC's high-income countries have a combined institutional property market size that is 60% of the US by value, or the sum of the UK, France and Germany. These are countries that meet the World Bank definition of high-income where GDP per capita was more than USD 12,736 in 2014. Adding China's 1st tier cities (where incomes are now above the World Bank's classification of a high-income nation, and property investment stock has expanded considerably over the past decade) pushes the universe close to 70% of the US. APAC's low to medium risk property investment universe is not as large as North America or Europe, and is heavily skewed to Japan (chart 4). This raises issues on how investors should allocate to APAC.

Two key points to highlight are:

1. **Access to core product.** The best quality assets are typically held long-term by local property companies or conglomerates. Accessibility to core product is likely to be difficult. Investors may need to take risks to access strong locations, with assets requiring capital investment, tenant leasing risk, or re-positioning to create a core asset.
2. **Concentration risk.** Japan is 45% of APAC's investment market. A long-term allocation to APAC is likely to have an underweight position in Japan, reflecting its weak macroeconomic and demographic fundamentals. However, a short-term allocation to Japan should account for how the market is priced, and seek to exploit the population growth of Japan's major cities as they draw in labour from the rest of the country.

Chart 4: APAC's low/medium risk property universe by property market value



Source: IPD, DTZ, Aberdeen Asset Management, 2014

Property investment themes

We favor strategies that use economic themes to underpin investments. We see this as particularly important at a point of the market cycle where many high quality or prime assets appear overpriced. Three major themes we have identified are:

1. **Urban population growth in high-income countries:** Population/household numbers are rising in many urban centres. Major cities are strong engines of growth as they attract skilled labour, and can capture the region's wider growth potential.

2. **Expansion of middle classes in developing economies:** Emerging country income growth should substantially increase the consumption of goods/services produced by APAC's developed economies.
3. **Population ageing in developed markets:** Many countries in APAC are ageing rapidly. Japan is the most advanced in the region but others are following such as China and Korea.

These themes give rise to a range of investment strategies in APAC's high-income economies across the retail, industrial, residential sectors, and niche market segments. However, we would note that not all strategies may be attractively priced in today's market environment.

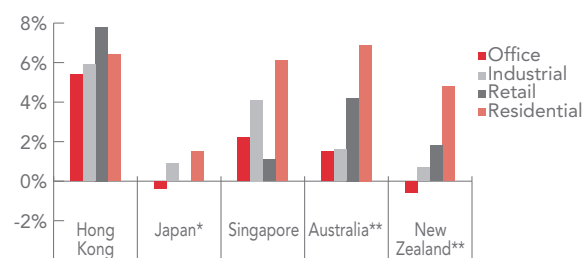
No offices?

Rising income and wealth in the region should support employment growth in professional, information technology and financial services industries, creating demand for office space. However, long-term office investment performance has been poor due to the ease of new developments (mostly through redevelopment of existing sites), and due to improvements in building space efficiencies.

We don't rule out office investments.

The most attractive office investments are likely to be short-term cyclical plays where values have suffered a significant drop; few such opportunities exist at present. Other sectors have delivered higher long-term returns, and the residential sector stands out strongly (see chart 5).

Chart 5: Capital value performance (1981 to 2014), % per annum change in US dollars



* Japanese data is for urban land prices, and is not broken down for the office and retail sector.

** Australian and New Zealand data commenced from 1984 and 1993 respectively.

Source: IPD, Urban Redevelopment Authority, Hong Kong Rating and Valuation Department, National Statistics offices

Conclusion

We see property investing risks in Asia Pacific's high-income economies converging with Europe and North America while also offering overseas investors exposure to high potential growth. APAC markets are becoming less risky due to rapid growth in the number of large financially strong local corporates – this trend has further to go given the long term growth of the region. Matching the expansion of the occupier base, there is a structural rise in domestic institutional capital which is translating into rising demand for APAC's income-producing property assets. This is an important development that creates property market depth, and gives overseas investors multiple exit options when they seek to sell.