Attractive Cyclical Investment Opportunities in Asia's Key Markets

Numerous long-term demand drivers support property investment in the key Asian gateway markets[1]. These drivers underpin future growth in the region and are part of the reason it bounced backed so strongly after the Global Financial Crisis (GFC).

This paper will focus on what we believe are three of the region's more important gateway markets, Singapore, Hong Kong and Seoul. Each market is expected to continue to benefit from multiple demand drivers, including, but not limited to, their ability to capture regional growth, corporate expansion and government investment. We will discuss the long-term demand drivers in the first section. We will then highlight key local market drivers for each city, and lastly, we will look at China's growth expectations and how healthier sustained growth is supporting investment in the key regional property markets.

Asia is expected to account for approximately 65% of global economic growth in 2014

LONG-TERM DRIVERS TO PROPEL MARKETS FORWARD: THE TIME IS NOW

Investment opportunities in Asia's key gateway markets will arise from several long-term demand drivers that together provide a compelling market opportunity; these include economic growth, urbanization, demographic changes, increased consumption and business growth. For example, Asia is expected to account for approximately 65% of global economic growth in 2014, with demand coming from both a pick-up in regional activity and the clear economic recovery in the West.[2] The countries where the key gateway market are located are projected to grow by approximately 6% p.a. through 2018, which compares favorably to the U.S. (3.0% p.a.) and Eurozone (1.4% p.a.).[3] This strong growth, from both consumers and corporates, supports demand for commercial real estate.

Global firms are confident about Asia's future as more than 85% of respondents to a recent survey[4] reported that they will increase or maintain their level of investment in the region. Additionally most firms are expecting the region to represent an increasing share of global revenue, for example consumer and retail firms expect the share of revenue from Asia to grow from 26% to 35% from 2013 to 2018[5].

[1]Our June 2013 research paper, "Asia Pacific Property: A Primer", noted Hong Kong, Singapore, Shanghai, Tokyo, Taipei and Sydney as regional gateway cities.
[2]Oxford Economics
[3]Oxford Economics
[4]Economist Corporate Network, Asia Business Outlook 2014
[5]Economist Corporate Network, Asia Business Outlook 2014

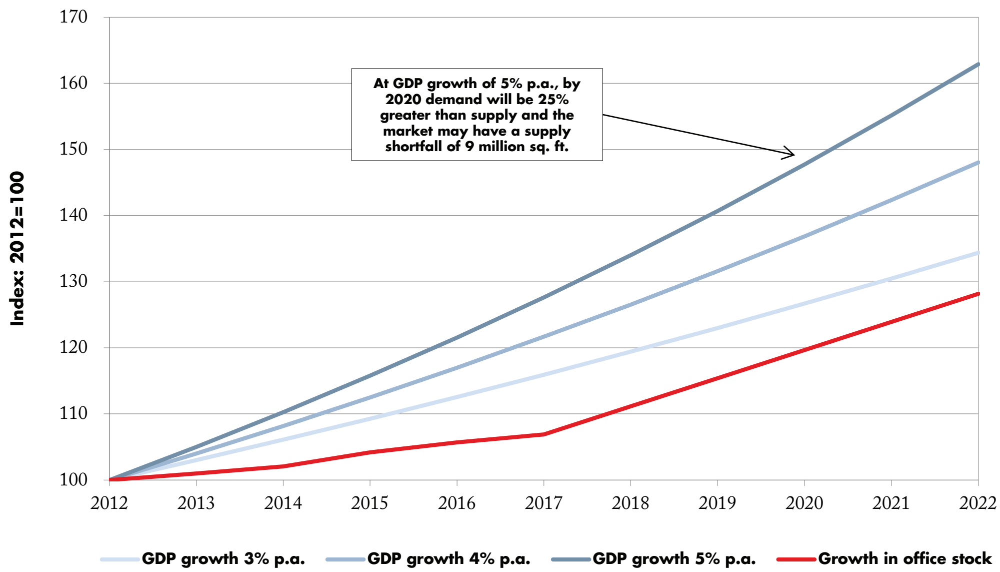
Further, many cities have key government-led infrastructure projects underway that are expected to be completed during the next few years. This infrastructure will help to sustain the long-term value of real estate assets. For example, Singapore has invested a vast amount in infrastructure projects designed to improve the transport network by adding new roads, extending the Mass Rapid Transit (MRT) and increasing the capacity of the airport. Similarly Hong Kong is further developing its infrastructure by improving its connection to the Mainland via high-speed rail, expanding the airport, building a bridge connecting Hong Kong and Macau and expanding the Mass Transit Railway (MTR).

HONG KONG: DEMAND TO EXCEED SUPPLY

Hong Kong is expected to face an office supply shortfall during the coming decade as demand exceeds new supply. Our analysis took into account projects under construction or proposed projects, as well as released and yet-to-be released land sites, to project the total potential office supply. When matched against various GDP growth rates[6] (Figure 1), it is clear that even under the lower growth scenario, there will not be enough supply to meet the increase in demand.

FIGURE 1

HONG KONG'S UNDER-SUPPLIED OFFICE MARKET



Source: Jones Lang LaSalle, AEW Research 2014

Much of the potential new supply is expected to be in the decentralized submarkets of Kowloon, Kwun Tong and the new 'CBD 2' in Kowloon East, which is just north of the retired Kai Tak airport. These are up-and-coming locations that offer considerably cheaper rents than Hong Kong Island and they have attracted manufacturing, trading and insurance occupiers.

Meanwhile, Hong Kong Island is a mature office market that has very few land sites available for development. High occupancy with vacancy limited to a few small spaces means a small demand rebound could substantially impact rents. We believe as the economy continues to grow there will be increased demand for desirable, well-maintained office space throughout Hong Kong.

[6]Land site data sourced from Jones Lang LaSalle

The retail market in Hong Kong should also provide investment opportunities and will be supported by both rising domestic demand and tourism growth. At the end of 2013, the average personal disposable annual income in Hong Kong was estimated to be almost USD 27,000 per person and may rise 34% (6.1% per annum) to more than USD 35,000 per person by the end of 2018.

The tourism market is an important contributor to total retail sales. In 2013 there were 54 million arrivals to Hong Kong and the Hong Kong Commerce and Economic Development Bureau is forecasting that this will rise to 70 million tourists annually within three years and 100 million within a decade, mostly from Mainland China.

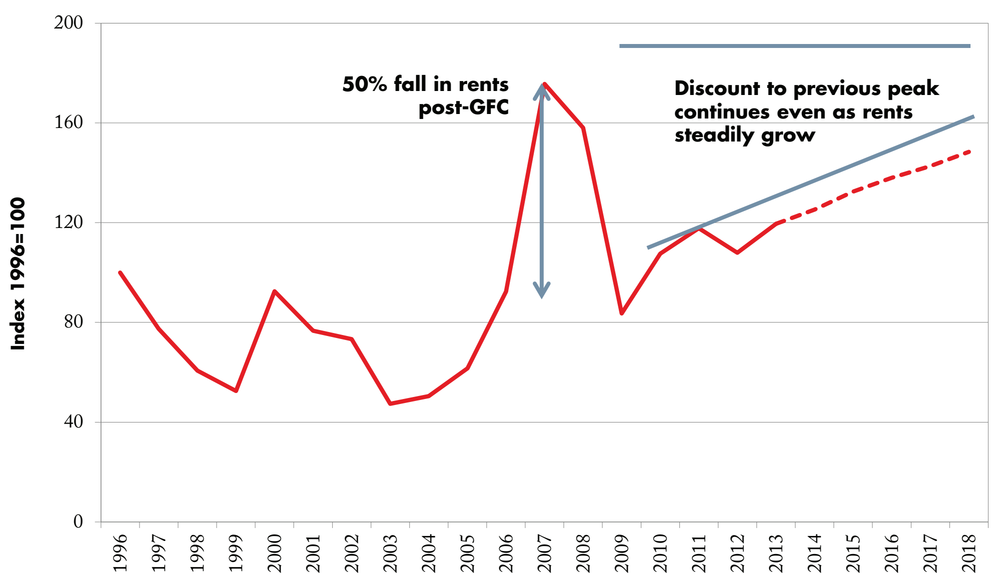
SINGAPORE: CYCLICAL RENTAL GROWTH

Singapore's office market is entering a cyclical rental growth phase as rents remain at a discount to their previous peak and vacancy is low. This presents a window of opportunity to enter the market at the beginning of the cycle.

Prime rents in Singapore are forecasted to rise 20% to 25% over the next few years

After a correction, office rents have started to rise again, up 7% during 2013. Leasing sentiment is positive and recently completed supply is being absorbed in to the market. Little additional office supply is expected to come online in the CBD over the next two years (+4% compared to +10% in the previous two years) and current occupancy rates are high and are projected to increase further. Compared to their previous peak, rents are at a heavy discount (about 40% in nominal terms and 30% in real terms) and when combined with a lack of available space for medium to large users, landlords are expected to be able to achieve higher market rents. Prime rents are forecasted to rise 20% to 25% over the next few years, after which they will continue to be lower than the previous peak. On top of market rental growth, most buildings today are under-rented and owners can expect positive rent reversion. AEW expects this to increase through to 2015 at least.

FIGURE 2
CYCLICAL RENTAL GROWTH IN SINGAPORE



Source: Jones Lang LaSalle, AEW Research 2014

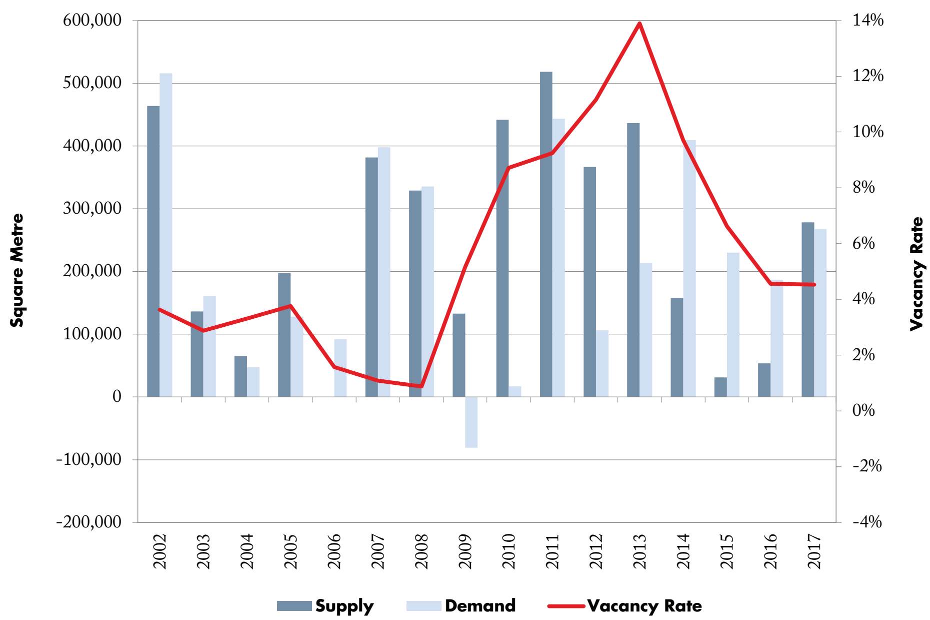
SEOUL: DECLINING VACANCY

Seoul's office market vacancy peaked during 2013 and is projected to decline to 4% by the end of 2016, presenting an opportunity to enter the market early in the cycle.

The Seoul office market has seen an influx of new supply over the past few years. The grade A office market in the three main business districts grew approximately 23% from 2011 to 2013. Over the next three years (2014 to 2016) the projection is for considerably less office completions totaling some 4% of total office stock.[7] Consequently, the vacancy rate is expected to decline as new supply is absorbed (Figure 3). Recent absorption levels have been very strong with the overall net absorption in the Seoul office market more than doubling from 2012 to 2013[8], leading to a decline in the overall vacancy rate. At the end of last year, the office vacancy rate was approximately 14% and by the end of 2015 it is projected to be less than half of that, reaching 4% by end 2016. The best market opportunity is in the Gangnam District, where there is minimal new office supply and vacancy has been low for a number of years (averaged 3.1% over the past two years). Additionally there may be opportunities beyond the traditional office sector. Service retail, such as medical or day surgery clinics, is a high demand segment in the Gangnam District and AEW believes this will be a growing niche industry.

FIGURE 3

DECLINING VACANCY IN SEOUL



Source: Jones Lang LaSalle 2014

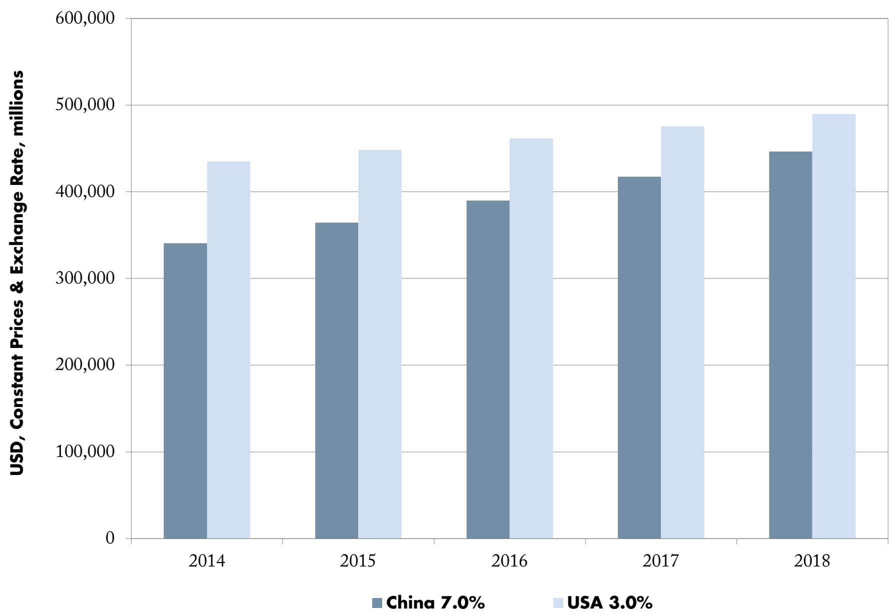
[7] *Jones Lang LaSalle*
[8] *Jones Lang LaSalle*

HEALTHIER MORE SUSTAINABLE GROWTH FROM CHINA

Over the past five years, China has been a stabilizing force for the global economy, accounting for more than a third of total global growth and for almost half of the emerging and developing economies growth[9]. China's economy is the second largest in the world, next to the U.S., and while their economy is growing at a slower rate than previously projected, the growth is still very impressive and produces large amounts of new economic activity every year. If China's economy were to grow at 7% p.a., it would produce additional annual output similar to the U.S. growing at 3% p.a.[10] (Figure 4).

FIGURE 4

COMPARISON CHINA AND U.S. GDP GROWTH



Source: Oxford Economics, AEW Research 2014

China's leadership is now working to manage economic growth so that it is more balanced, inclusive and in fact healthier. The resulting slower rate of growth has the benefit of being more sustainable and stable over the medium- to long-term. As the government rebalances and as a higher proportion of growth comes from consumption and the service sector, it is estimated that private consumption as a share of real GDP growth will increase from 27% (2000 to 2010) to 41% (2010 to 2020)[11]. This is being achieved, in part, by the government focusing on improving productivity and assisting the Small and Medium Enterprises (SME) sector. Moreover, this shift is being supported by low household debt, high savings and income growth. McKinsey predicts that by 2022 a new upper middle class, earning between USD 17,000 p.a. and USD 37,000 p.a., will account for 54% of China's urban residents and 56% of urban private consumption. We believe these gateway markets (Hong Kong, Singapore and Seoul) will continue to be the largest, most dynamic, attractive and mature destinations for investment and that they will capture much of this rise in spending power.

[9]Speech by Christine Lagarde, Managing Director, IMF, March 24, 2014
[10]GDP at constant prices and exchange rate (USD)
[11]McKinsey & Company, 2013

CONCLUSION

AEW believes Asia's gateway markets provide good risk-adjusted entry points for global investors. Gateway markets provide a low-risk entry point due to a number of characteristics including: their ability to capture regional growth, high transparency and liquidity. Structural growth drivers will also help support these markets through cyclical ups and downs. Additionally, we have identified key value drivers in three key regional gateway markets that indicate that we are at an attractive point in the cycle to invest. Hong Kong is expected to see a supply shortfall, Singapore is starting a cyclical rent upswing and Seoul is seeing a decline in the office vacancy rate. The dominate economy in the region, China, is targeting better quality, sustainable growth of between 7.0% and 7.5% as they move towards a higher contribution to economic growth from private consumption. As a result productivity and incomes are projected to rise. Combined, all these factors make now a very compelling time to invest into these markets.

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