

AEW RESEARCH

# ASIA PACIFIC MARKET PERSPECTIVE

Q4 2016





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*Cover: Sydney, Australia skyline*

## General Economic Overview

World growth in 2016 has been estimated by the International Monetary Fund (IMF) to be 3.1% but this average growth rate masks divergent trends among countries. The U.S. is nearing full employment and activity rebounded in the second half of the year after a slow start. At the same time that the U.S. is building some expansion momentum, output remains below potential in several other advanced economies, notably in the Euro area. The outlook for 2017 is for similar diverging paths with good U.S. growth and underwhelming European demand.

Proactive policy support and healthy domestic demand has allowed gateway market economies to grow comparatively well during 2016. This is despite a very high level of global uncertainty, not the least of which came from the Brexit vote and U.S. election result. Global trade picked up during 2016, and early 2017 export data suggests momentum is continuing.

China continues to transition its economy towards being more service sector orientated with an increasing share of economic activity coming from consumption. As it undertakes this long-term program of reform, the growth rate will naturally reduce to a more sustainable level. Government spending and monetary policy has been focusing on limiting the impact of this lower growth on the labor market, ensuring the decline in growth is gradual and financial and capital markets are underpinned by robust policy with a stability target.

Growth in China during 2016 was targeted to be 6.5% to 7.0% and in the early release of full year GDP growth estimates it was 6.7%. Full year results were aided by a robust second half of the year, in particular a strong fourth quarter. A loosening of policies in the residential real estate sector supported activity by increasing construction growth and manufacturing pick up.

Last year's actual expansion of 6.7% may be China's slowest pace of growth in 26 years, but it remains within the range for Beijing to meet its longer-term goal of doubling GDP and per capita income by 2020 from 2010 levels. Lower growth is now being more positively received, with less immediately negative reaction upon release. The market now accepts structural reforms and the changing composition of growth are more important than the pure quantity of growth.

In early March Premier Li Keqiang announced the 2017 GDP growth target will be 6.5%, consistent with expectations and long-term growth targets. His report to the National People's Congress in Beijing outlined an economic policy approach focused on stability and addressing risks where they were forming.

Gateway currencies were generally weaker against the USD during 2016. USD strength during the second half of 2016 reflected both the pickup in U.S. growth and, latterly, an uptick in reflation expectations post-election. A higher USD and weaker local currency is making the exports of gateway markets, and their manufacturing sectors, more competitive in global markets. This is also one of the drivers of the current surge in export volumes.

Expectations are for a modest rise in Consumer Price Index (CPI) inflation. This is on the back of some cost-plus pressure (now that the Producers Price Index inflation is broadly positive across the region), and low base comparisons from a year ago. A recent increase in the oil price has raised inflation expectations but most forecasts are for a limited increase in oil prices from this point forward. Monetary policy across the region is expected to remain largely accommodative.

Demand in the retail sector will continue to come from necessity related retailers

The next move by both Korea and Australia could be for rate declines; however, their central banks will likely be watching import prices pressures as well as Fed rate hikes and forward guidance. Singapore will likely continue its mostly neutral stance. China's PBOC is expected to gradually tighten monetary conditions in order to maintain financial sector stability.

## Property Market

In a world of improving economic fundamentals, occupier conditions across key gateway markets are generally favorable. Many markets have a constrained new construction pipeline and where supply is being completed there is ample demand to absorb it. Tech-related firms and domestic financial companies have underpinned office leasing demand.

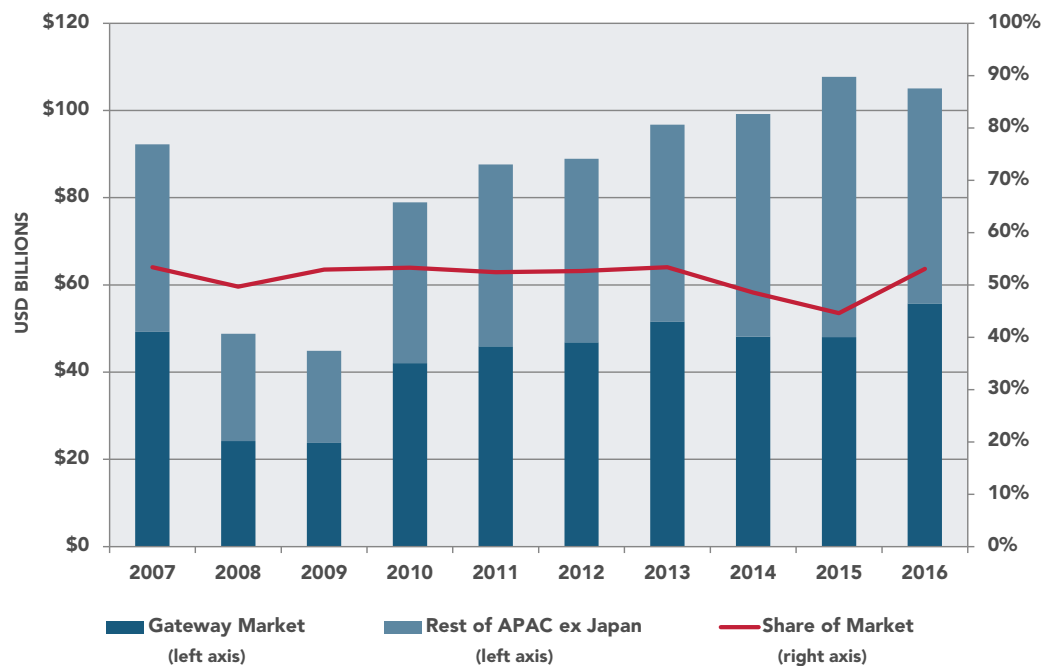
Demand in the retail sector will continue to come from necessity related retailers with a focus on Food and Beverage (F&B), service related and mid-market fashion brands. In addition some global brands are expected to selectively expand store count in new markets. Demand for residential units remains high, albeit constrained by policy targeting excess price increases. Serviced apartments will benefit from gateway markets enduring focus on being global cities, attracting international talent.

Asia Pacific income-producing (excluding development sites) USD sale volumes fell about 13% in 2016 compared to 2015. In Japan, activity was down in both USD and local currency terms. In contrast, activity in the gateway markets rose a strong 12% during the year. In USD terms, transaction activity was highest in Shanghai and Hong Kong. Seoul grew the fastest, up almost 100%, due in part to the sale of the mixed-use IFC Seoul to Brookfield (USD 2.2 billion, USD 548 per square foot on the office portion). Excluding the IFC deal from Seoul's activity, sale volumes were up 43%, still the fastest growing market. Singapore volumes were up 39% during the year, but the sale of Asia Square Tower 1 (USD 2.47 billion, USD 1,925 per square foot) was a large contribution to this; once removed, sale volumes were down 4%. These two individual transactions were among a few very large deals during the year. The largest was the October sale of Shanghai Century Link by Hong Kong developer Cheung Kong for USD 3 billion (USD 773 per square foot) to Singapore based ARA Asset Management. Sydney saw volumes fall by 17% but this is after three very strong years of sales activity. Activity was much stronger than the 2007 to 2015 average.

The bond sell-off during the final quarter of 2016 returned bonds back to where they started the year. Analysis by the AEW Research team in the U.S. indicates U.S. treasuries will not rise too much further from their current 2.4% levels, especially if global alternatives such as the 10-year German Bund and Japanese 10-year JGB continue to yield close to 0%.

Yield spread between gateway markets property yield and the local currency 10-year sovereign bond yield continues to be wide. Capital allocated to regional real estate markets for an income premium over bonds is expected to continue to be deployed in mature, gateway markets. The spread is also providing room for bond yields to rise before they start to impact real estate cap rates.

GATEWAY TRANSACTION VOLUME



Source: RCA

## Hong Kong

### KEY REAL ESTATE INDICATORS

	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES
Office (CBD)	1.7%	↑	↑	↓	↔	↔
Retail (Shopping)	1.8%	↑	↓	↑	↑	↔
Residential	3.7% <sup>A</sup>	↔ <sup>A</sup>	↔	↓ <sup>A</sup>	↑ <sup>B</sup>	↔

<sup>A</sup> As at December 2015, the latest period reported

<sup>B</sup> As at December 2016

Source: JLL, Hong Kong Rating and Valuation Department

Note: For the vacancy rate, rents and cap rates the arrows reflect the trend for the current quarter compared with the comparable quarter one year earlier. For absorption and completions the arrows reflect the 12-months through to Q4 2016 trend compared with the 12 months through to end Q4 2015. For vacancy rates, a down arrow indicates declining vacancy rates or an improvement in market fundamentals. For cap rates, a down arrow indicates lower cap rates.

Hong Kong's economy grew by 1.9% year-on-year, a result that was at the high end of the government's 1% to 2% guidance. Seasonally adjusted quarterly data indicate there was a strong pick up during the fourth quarter, with quarter-on-quarter growth increasing from 0.8% in Q3 to 1.2% in Q4. High frequency indicators such as the Purchasing Managers Index (PMI) survey, goods exports and tourist arrivals support this view as well.

GDP growth for 2017 is anticipated to be about 1.9%, building to 2.3% in 2018. Domestic demand is a large part of this growth, growing 2.5% and 2.6% in 2017 and 2018 respectively. The gain in domestic activity is broadly based, with private and government consumption and fixed investment all growing at similar levels. In particular consumer spending is expected to be supported by a healthy job market and relatively stable asset prices. Inflation is expected to remain low for several years, at about 2.5% per annum, very similar to the 2.4% in 2016.

Demand for grade A office space continues to be supply constrained, especially on Hong Kong Island. The Hong Kong Island vacancy rate was stable at 2% and has been less than 3% since 2014. During the quarter Hong Kong Island saw a loss of about 700,000 square feet of occupied space, due mostly to the withdrawal of Warwick House in Hong Kong East which is being demolished as part of Swire Properties redevelopment of Taikoo Place.

In Central, where the vacancy rate is only 1.7%, leasing demand was largely underpinned by the expansion and new-set up requirements of mainland Chinese financial services companies. These firms accounted for about 54% of all new lettings (by floor area leased) during the final quarter.

Vacancy rose over the fourth quarter in the Kowloon East submarket, from 7.2% in Q3 to 10.5% in Q4, a trend that is expected to continue over the next several years due to the coming supply cycle. Kowloon East stock grew by about 6% over 2016, and is expected to rise by another 10% in 2017, the peak of the cycle. Vacancy in this submarket is forecast to peak during 2019 when it reaches 15% as stock grows by another 6%.

Contrasting this, Central vacancy is likely to remain at or below 3% for a number of years as new supply is very low and demand continues to be robust. The submarket is considered supply constrained and occupiers looking to expand their presence have almost no options available to them. The current outlook is for market yields to remain stable over the coming several years, with rents and capital values moving in line which each other.

There was good demand from mass-market retailers such as mid-price apparel retailers

There is expected to be a mild, market wide, supply induced rental correction in 2018 and 2019 as supply is absorbed.

The demand supply fundamentals of individual submarkets will determine their performance. For example, Central, where there is no supply anticipated until 2021, will be the most defensive submarket. Forecasts are for Central rents to grow by slightly more than 4% during 2017, and then correct by slightly less than 4% in 2018. Consequently landlords should expect to be able to renew leases at about current levels over the coming 24 months. Three-year leases expiring during 2017 could revert at 20% to 30% premium to passing rents.

Against an improving inbound tourism market and retail sales which are forecast to stop falling this year, the two-year long decline in Hong Kong's retail sector appears to be coming to an end. The inbound tourism market showed signs of stabilization with the contraction in total visitor arrivals narrowing to 2.3% year-on-year in October-November.

Supported by improvements in inbound tourism and a robust labour market, the slump in total retail sales narrowed to 2.9% year-on-year in December. Jewelry & watch sales increased year-on-year in December, the first increase since late 2014 - this may turn out to be a short-term rebound. Luxury retailers continue to downsize, reducing the number of stores and focusing on per store performance.

There was good demand from mass-market retailers such as mid-price apparel retailers, including active fashion brands, and cosmetics. These brands are looking to take advantage of the almost 40% decline in rent for well-located retail space in traditional prime retailing districts. Retail sales are forecast to grow by 1.5% during the year, supported by favorable domestic conditions such as stable employment and a steady increase in wages. Private consumption is expected to grow by 2% in 2017.

Against this backdrop AEW is anticipating a gradual improvement in the retail sector during 2017, especially in the second half. Leasing momentum is expected to pick up, though a large proportion of activity will likely be driven by retailers looking to focus on store performance. In addition retailers are looking for rental reductions upon expiry.

The still-stable domestic spending and proliferation of dining-out should continue to see F&B operators, primarily local mass catering groups and overseas casual-dining eateries, drive demand in the leasing market.

Landlords continued to offer concessions as much as 50% on rents as they seek to maintain occupancy levels. High street shop rents are expected to bottom out in 2017 after declining 0-5%. The peak to trough cumulative rental correction will be around 40% (more in some cases). On the back of improving retail sales and sentiment, rents are forecast to increase in the range of 0-5% each year from 2018 to 2021.

In the investment market local investors are expected to become more active this year, in search of bargains and value-add opportunities to capitalise on the gradual recovery of the retail market. AEW expects buying momentum to gather pace. Investors are likely to focus on retail properties in mass market-oriented areas, notably well-located street shops and neighborhood shopping centers, which can provide investors with a steady rental income stream.

HONG KONG ISLAND OFFICE DEMAND, SUPPLY AND RENTAL OUTLOOK



Source: JLL



# Singapore

## KEY REAL ESTATE INDICATORS

	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES
Office (CBD)	6.7%	↑	↓	↓	↓	↔
Retail (Shopping Center)	3.9%	↑	↓	↑	↓	↔
Residential	8.9%	↑	↓	↑	↑	↔

Source: JLL, Singapore Urban Redevelopment Authority

Note: For the vacancy rate, rents and cap rates the arrows reflect the trend for the current quarter compared with the comparable quarter one year earlier. For absorption and completions the arrows reflect the 12-months through to Q4 2016 trend compared with the 12 months through to end Q4 2015. For vacancy rates, a down arrow indicates declining vacancy rates or an improvement in market fundamentals. For cap rates, a down arrow indicates lower cap rates.

Singapore's economy grew 2.9% year-on-year in 2016. Activity picked up during the fourth quarter after a slower third quarter during which growth was 1.2% year-on-year. On a quarter-on-quarter seasonally adjusted annualized basis the economy increased 12.3% in the fourth quarter, a marked turn around from the 0.4% contraction in the third quarter.

Growth of 2.9% was above the government's expectations of 1% to 1.5% full year growth. Domestic demand strengthened in Q4, led by a solid increase in both government consumption and non-residential investment. Household spending also turned positive. Exports recorded another quarter of solid growth, driven by an acceleration in biomedical and electronics shipments. Moreover, recent monthly trade data suggests that this solid momentum has continued into 2017.

Expectations are for growth to pick up during 2017, to 2.4%. There should be a modest recovery in the services sector and fiscal spending will remain supportive. A key risk to the outlook is the possible rise in trade protectionism; Singapore is a small yet highly open economy which is exposed to the global trade cycle.

The office sector will likely find its inflection point during 2017. CBD rents, which started to correct early in anticipation of supply due to complete at the end of 2016 and early 2017, have now fallen about 20% (premium rents are estimated to have adjusted down by about 27%).

Commitment in this new construction has been strong. Gucco Tower (880,000 square feet), which completed during the fourth quarter of 2016, is now more than 90% committed. Marina One (1.88 million square feet) is more than 60% pre-leased and after some delays is estimated to be complete by the end of the second quarter. The only other supply is the UIC Building (285,000 square feet). This redevelopment is expected to be completed during the second quarter as well.

Overall CBD vacancy edged up during the fourth quarter, ending the year at 6.7%, only slightly above the 5% at the start of the year. As supply is completed it is expected the vacancy rate will peak at the end of 2017 at about 12%, before declining thereafter.

With the office sector likely to trough during 2017, it presents investors an attractive entry point. Entering at this point, ideally with a long WALE, well located asset, provides the opportunity to enter a highly transparent, global gateway market and position for a recovery in the occupational market as demand and supply become more balanced.

Retail sales in Singapore continued to trend down during the second half of 2016. The overall sales index contracted 2% year-on-year in November, the 15th consecutive month of decline. Declines were seen across most categories. Against a reasonably soft labor market backdrop, spending on necessity items has been limited and is cautious. However necessity spending on staple items continues to be steady. The outlook is for sales to pickup this year, rising 3.2% with momentum continuing into 2018 when sales are forecast to grow by 5.6%.

Leasing activity in the retail sector continues to be slow in a challenging operating environment. Food and beverage retailers are finding the environment difficult as residents spend less on eating out, or are searching for more economical choices. There has been and will continue to be a heavy focus on individual store performance. In addition as consumers move towards omni-channel, shopping center based retailers and landlords are focusing on experiences and convenience by increasing mall amenities.

AEW continues to believe in the long-term robustness of the Singapore consumer and therefore the neighborhood retail sector. Unemployment remains low and incomes have grown strongly over a long period of time. Real personal disposable incomes are estimated to have grown on average 4.7% per annum in the six years to end 2016. Additionally, Singapore consumers have a strong household balance sheet.

Pricing in the residential sector has adjusted down for several years and the price correction is most acute in the high-end sector. The overall price index is down 11% over 13 quarters, while high-end pricing is down almost 20% from its peak in the same period. Recent sales activity is suggesting pricing in the high-end sector is starting to recover, indicating an attractive entry point for institutional investors. Additionally, some developers are now facing a tax on unsold inventory that makes it attractive to accept a discount to market.

There were several key transactions during 2016. The most high profile and largest was the June sale by Blackrock of Asia Square Tower 1 (USD 2.47 billion, USD 1,925 per square foot). Second to this was the land sale of the nearby Central Boulevard site in November for USD 1.9 billion to the Malaysian IOI Group.

Early in 2017 investors continue to show interest in entering the Singapore market. In February it was announced DBS Group Holdings a Singapore listed bank, would sell the PWC Building for USD 528 million (USD 1,486 per square foot) to a unit of Manulife. Initial press reports indicate Manulife intends to self occupy some of the space by 2019.

Yields in Singapore continue to be tight reflecting the amount of capital looking to be deployed into this highly transparent gateway market. Office yields are about 3.5% currently, while prime, well-located shopping centers are being valued at about 4%.

Real estate continues to provide a positive spread over the risk free rate, attracting long run, income-seeking investors. Manulife indicated this was one of the factors driving their decision to purchase the PWC Building.

The local currency government bond yield ended 2016 at a level very similar to where it began the year, 2.43%. Through to the end of February the yield firmed even more to 2.3%, increasing the spread and supporting capital targeting the real estate sector.

SINGAPORE CBD OFFICE DEMAND, SUPPLY AND RENTAL OUTLOOK



Source: JLL

## Seoul

### KEY REAL ESTATE INDICATORS

	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES
Office (Overall)	11.8%	↑	↑	↓	↑	↓
Office (CBD)	15.6%	↑	↑	↓	↓	↓
Office (Yeouido)	14.5%	↑	↑	↓	↔	↓
Office (Gangnam)	6.7%	↑	↑	↑	↔	↓

Source: JLL

Note: For the vacancy rate, rents and cap rates the arrows reflect the trend for the current quarter compared with the comparable quarter one year earlier. For absorption and completions the arrows reflect the 12-months through to Q4 2016 trend compared with the 12 months through to end Q4 2015. For vacancy rates, a down arrow indicates declining vacancy rates or an improvement in market fundamentals. For cap rates, a down arrow indicates lower cap rates.

The South Korean economy grew 2.7% in 2016, consistent with the 2.6% expansion in 2015. Momentum eased off during the final quarter of 2016 as the construction boom that was partially supporting growth in the first nine months started to ebb. Housing market sentiment has diminished and the appetite for additional credit in today's environment has reduced.

The slight reduction in growth to 2.4% in 2017 is a reflection of this lost momentum continuing in the early part of 2017. The uncertainty associated with the impeachment of the president has lowered consumer sentiment and retail sales growth. Corporate sentiment is also being affected with private investment growth expected to be lower this year than last, as certain decisions are delayed.

With the impeachment process anticipated to be completed sometime during the first half of 2017, conditions in the second half could improve. Economic policy continues to underpin the economy. There is little inflation pressure forming and CPI inflation is expected to be under 2% per annum for several years. This is providing the central bank significant room to keep monetary policy highly accommodative. Policy settings are downward biased, and the next interest rate move is likely to be further reduction in the policy rate. Fiscal policy is also expansionary and supportive.

Lastly recent export data is promising. As domestic conditions are temporarily challenging, higher global growth is benefiting the external sector. Export growth in February 2017 was the strongest in five years. Higher oil prices are spilling over into petrochemical exports, while semiconductor and motor vehicle export growth has also improved in the early part of 2017. Korea continues to run a trade surplus, which increased by around USD 462 million in February to USD 7.2 billion.

The supply outlook in Seoul's office market continues to be well below trend levels. There are no new for-lease, grade A projects expected to be completed this year. In 2018 there is forecast to be one new project in each of the traditional business districts, with a total of about 2.2 million square feet. Then in 2019, again, no new projects are forecast to enter the market.

Net absorption during the fourth quarter was a strong 890,000 square feet (full year 424,000 square feet), a turn around from the net loss of occupied space over the previous nine months of 470,000 square feet. Much of the demand pick up is due to the relocation of several large domestic tenants and the expansion of WeWork to the CBD, after successfully entering the Gangnam market.

The supply outlook in Seoul's office market continues to be well below trend levels



Yields continued to tightened during 2016. Grade A office yields started the year at about 4.7% and ended it at around 4.5%.

The demand outlook for 2017 is reasonably subdued, with a net loss of about 364,000 square feet of occupied space. The main driver of this is further relocation of major domestic corporations. They will vacate leased space for owner-occupied stock.

Moreover new leasing demand during the first half of the year is likely to be impacted by the subdued near-term economic outlook and uncertainty surrounding domestic political issues. The second half of the year will likely show more leasing activity than the first as the economy picks up and fewer decisions are delayed.

At the end of 2016 the vacancy rate across all three business districts was 11.8%, up slightly over the year from 11% at the end of 2015. With a mild leasing environment the vacancy rate at the end of 2017 is expected to be about 13%. It is forecast to reduce to 10% by 2019 as demand exceeds supply.

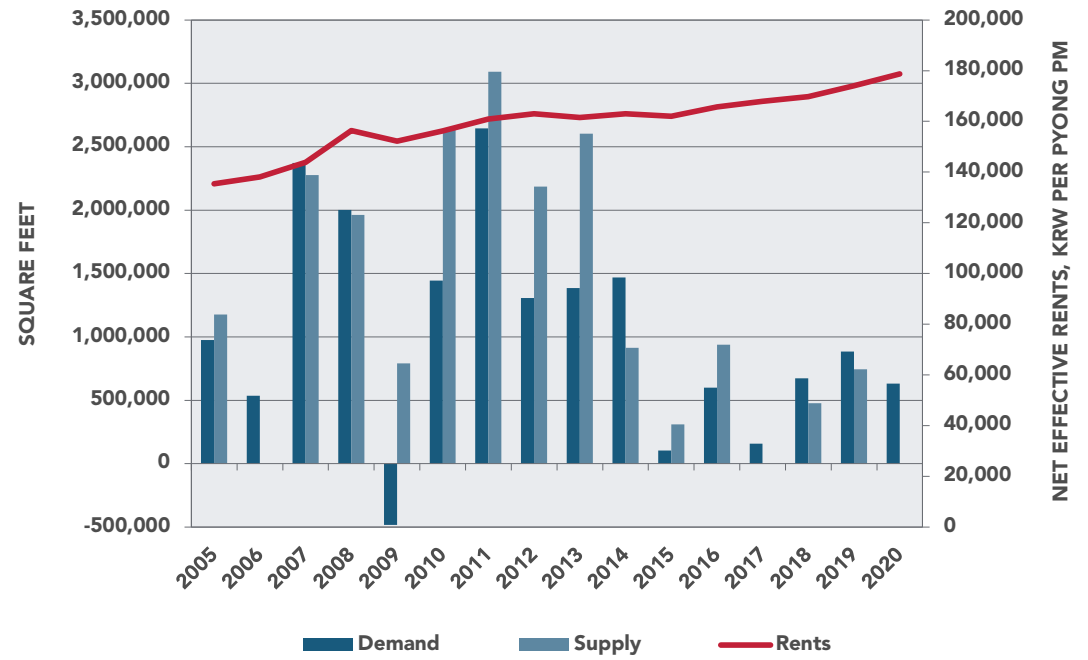
There were several large transactions last year, led by the sale of the International Finance Center Seoul for USD 2.2 billion dollars. The next largest sale was the Renaissance Hotel for USD 596 million, a future mixed-use redevelopment site.

Transaction activity continues to be strong in the early part of 2017. Taepyeong-ro Building was reportedly sold in January for USD 190 million (\$442 per square foot). T Tower sold in the same month for USD 156 million (USD 349 per square foot) to PGIM Real Estate from a local institutional investor. T Tower is in a district of the CBD where vacancy has been structurally high, in Q4 the vacancy rate was 24%.

Yields continued to tighten during 2016. Grade A office yields started the year at about 4.7% and ended it at around 4.5%. Investors continue to seek stable, income producing assets in Seoul and foreign activity is increasing. The availability of comparatively high yields with low financing costs mean the greater than 7% cash-on-cash returns investors can expect are highly attractive – and Korea's open capital account means the income return can be repatriated. Local currency sovereign 10-year bond yields were around 2.1% at the end of the year, boosting interest from domestic investors in real estate.

Seoul offers the opportunity to lease selective, well located and cost competitive vacancy. It also provides the opportunity to restructure leases which may have significantly above market concessions. Reducing these lease incentives can dramatically improve bottom line NOI while retaining occupancy, lowering the overall risk profile.

SEOUL OFFICE DEMAND, SUPPLY AND RENTAL GROWTH OUTLOOK



Source: JLL

# Shanghai

## KEY REAL ESTATE INDICATORS

	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES
Office (CBD)	5.0%	↑	↑	↓	↑	↔
Office (CBD - Puxi)	3.9%	↑	↑	↓	↓	↔
Office (CBD - Pudong)	7.9%	↑	↑	↓	↑	↔

Source: JLL

Note: For the vacancy rate, rents and cap rates the arrows reflect the trend for the current quarter compared with the comparable quarter one year earlier. For absorption and completions the arrows reflect the 12-months through to Q4 2016 trend compared with the 12 months through to end Q4 2015. For vacancy rates, a down arrow indicates declining vacancy rates or an improvement in market fundamentals. For cap rates, a down arrow indicates lower cap rates.

In the office sector overall demand remains very high with 5.6 million square feet of take up

Shanghai has one of the most developed city economies in China. The tertiary sector accounted for 70.5% of Shanghai's total economic output and grew 9.5% last year. In contrast, manufacturing in Shanghai grew about 1.2%. The expansion of the service sector was the primary driver of Shanghai's 2016 GDP growth of 6.8%.

Two industries in the tertiary sector saw double digit growth over the past year. Leading the growth was information transmission software, and IT services, which grew 15.1% year-over-year. Next was financial services, which grew 12.8% year-over-year.

City level officials are comfortable with the recent decline in home prices and volumes in Shanghai, citing it as good for the overall economy. During the year the government tightened the rules covering down payments and mortgages to control rising prices. New home prices edged down 0.1% month-on-month in November and declined a further 0.2% in December.

In the office sector overall demand remains very high with 5.6 million square feet of take up. The large majority of this take up was in decentralized locations. Low rents and high vacancy in these peripheral locations is offering cost conscious CBD tenants and upgraders additional leasing options to consider. Decentralised rents increased 4.4% year-on-year in the fourth quarter thanks in large part to new projects and the maturing of some grade A clusters. Rents are forecast to correct mildly during 2017 as supply is high, before starting to grow again from 2018 onwards as demand and supply become more balanced.

Net absorption in the CBD continues to be positive, albeit take up is lower than historic averages. While Pudong CBD recorded strong net absorption in the beginning of the year, leasing activity slowed towards year-end. Domestic firms continued to lead demand, but expanded less aggressively compared with last year.

Overall Puxi CBD leasing demand continued to weaken due to rising competition from decentralised projects as well as added supply. Non-finance professional services (such as law firms and recruitment companies) continued to be active. In addition, technology, media, and telecommunications (TMT) companies became more active in the CBD with upgrade and new set-up requirements.

CBD rents had a strong first half of the year, but increasing competition from decentralised areas and upcoming new supply led rents to ease toward the end of the year. In Pudong CBD the delay of several new projects, including the completion of Shanghai Tower, has increased the 2017 supply

and vacancy rate outlook and created short-term pressure on landlords. In Puxi CBD fringe locations rapidly developed in 2016, and have provided stronger-than-expected competition for CBD projects, as mentioned. CBD landlords are under increasing pressure to offer attractive rents to retain and attract tenants, but remain conservative in doing so, and decentralised landlords still need to maintain a discount to CBD comparables to convince CBD tenants to relocate.

Shanghai's investment market remains very strong, and in 2016 it was the region's most active market, overtaking Tokyo. Office assets continue to attract a significant amount of capital. The largest transaction last year was the October sale of Shanghai Century Link an office development in Pudong for USD 3 billion (USD 773 per square foot).

Early in 2017, sales activity continues to suggest strong investor appetite. It is understood Poly Greenland, a domestic developer, divested an office and retail mixed-use project in February for a combined USD 232 million. In addition, China CTS Tower, a suburban office tower, is likely to be sold for USD 199 million. There have also been several other office projects sold around the Hongqiao area.

Office yields firmed during 2016, as an increasing amount of capital chased deals. Current NOI yields are estimated to be around 4% but analysis of transactional evidence suggest deals have been done under 4%.

Shanghai's Statistics Bureau released retail sales figures that showed growth between January and November 2016 of about 7.8% year-on-year. Overall leasing patterns remained similar to earlier in 2016. Luxury retailers continued to adjust their store portfolios while major fast fashion brands are opening fewer stores. F&B demand remained strong, particularly in decentralized malls from mid-range restaurants.

There has also been a robust expansion of small format F&B chains (generally 500-800 square feet) such as juice bars and salad shops, which have benefited from collaboration with mobile take-out dining apps. Children's education brands continue to expand, especially in decentralized community malls. Fitness centers, sportswear brands and other tenants selling healthy lifestyles also continued their aggressive expansion.

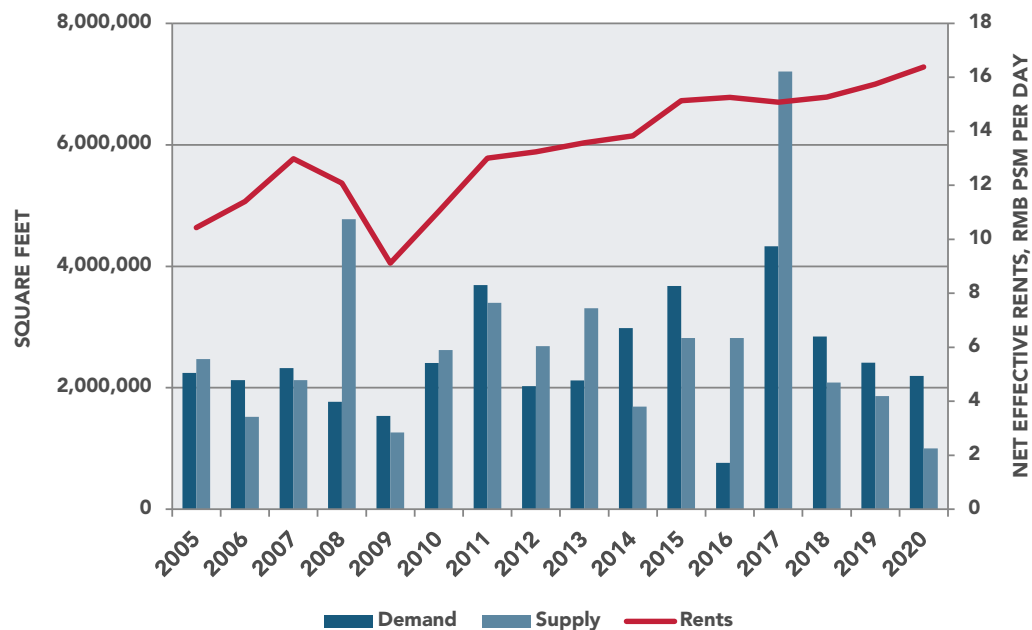
Prime open-market ground floor base rental growth was 1.3% year-on-year as at end Q4. Prime rents have been impacted by weak or falling rents in submarkets like West Nanjing Road. Overall performance has suffered due to leasing competition from decentralized malls and recent new completions have struggled to gain traction. Decentralized rental growth held up better, 2.9% year-on-year in Q4.

The largest retail transaction last year was Jinqiao Life Hub at USD 823 million (USD 667 per square foot), to a local private investor who specializes in the retail sector. The portfolio sale of Joy City Mixed Used Projects included a Shanghai asset with an estimated value of USD 713 million (USD 151 per square foot).

AEW continues to believe the Shanghai market provides attractive opportunities to generate value add returns. Active management of office assets to increase their rents and revert expiries at significant premiums to passing income offers investors the ability to rebase NOI higher.



SHANGHAI CBD OFFICE DEMAND, SUPPLY AND RENTAL OUTLOOK



Source: JLL

## Sydney

### KEY REAL ESTATE INDICATORS

	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES
Sydney CBD	8.7%	↑	↑	↓	↑	↓

Source: JLL

Note: For the vacancy rate, rents and cap rates the arrows reflect the trend for the current quarter compared with the comparable quarter one year earlier. For absorption and completions the arrows reflect the 12-months through to Q4 2016 trend compared with the 12 months through to end Q4 2015. For vacancy rates, a down arrow indicates declining vacancy rates or an improvement in market fundamentals. For cap rates, a down arrow indicates lower cap rates.

A significant uplift to new building completions and withdrawal activity was recorded across the Sydney CBD office market in 2016. Completion of the two largest office towers at Barangaroo South over the year have advanced the precinct as a new hub for commercial and economic activity.

In contrast, the increase in office building withdrawals was necessary to establish the next wave of new office, apartment and hotel developments across the CBD and for the further improvement in transport infrastructure. Approximately 1.4 million square feet was taken out of stock during the year. A total of seven buildings were withdrawn from the Sydney CBD office market in the fourth quarter, totalling slightly more than one million square feet.

Two projects completed within the Sydney CBD office market in Q4, one located within the Core and the other within the Western Corridor precinct. The final and largest of the office towers at Barangaroo South, International Towers Sydney – Tower 1 (1.08 million square feet), reached practical completion. It was approximately 48% pre-committed, with some additional leasing activity recorded post the practical completion date. Charter Hall's development at 333 George Street, Sydney (12,453 sqm) was the only other project to complete over the quarter. The building had received 100% commitment as at end-December 2016.

Underlying demand within the Sydney CBD office market is very strong and the leasing market is very competitive. Demand is being fuelled by the strength of the New South Wales (NSW) economy and an unprecedented level of stock withdrawals over 2016. As secondary stock is being taken out of the market and prime is completed, the vacancy rate trend for each continues to diverge. During the quarter the prime vacancy rate rose 120 basis points to 8.7%, while the secondary vacancy rate fell 30 basis points to 6.3%.

Contracting supply, low vacancy rates and high demand are being reflected in secondary rents. During the year face rental growth was 16%, and with the 28% fall in incentives, effective rents are up 42%. In contrast, the prime market, where vacancy is higher due to recent completions, incentives continue to be high, albeit reducing. Effective prime rental growth was also strong, up 22% for the year.

Forecasts are for rents to continue to rise strongly. Incentives, especially in the secondary markets, will continue to fall, and leasing competition will increase face rents. Prime face rents, for which forecasts are available, are anticipated to rise 7% in 2017, and net effective rents will increase 12%.

Investor demand remains robust for Sydney CBD office stock. However, access to product remains a key challenge for investors. The largest transaction recorded for the quarter was the sale of 33 Alfred Street. Several AMP related funds acquired the asset from AMP Life. Following the highly landlord favorable occupier market, investor appetite continues to be very strong and a highly competitive bidding process firmed market yields over the year. Prime yields ended the year at 5.3%, down from 5.5% at the start of the year. Secondary yields firmed from 6.1% to 5.75%.

Total retail turnover grew by 3.6% year-on-year in November 2016, down from 5.7% in November 2014. The slowdown since 2014 has been driven largely by food (groceries), household goods, cafes, restaurants and takeaway food, and more recently (since May 2016), department stores.

Consumer sentiment has held up well in Australia in the second half of 2016 given the global events and uncertainties caused by the Brexit referendum (June) and the U.S. election (November). In addition, labour market conditions remain healthy. The national unemployment rate was relatively stable through 2016, at 5.8% in December 2016.

Deloitte Access Economics (DAE) forecasts inflation-adjusted retail turnover growth to slow from 3.1% in 2015 to 1.9% in 2016, before rising to 2.1% and 3.0% in 2017 and 2018. Over the long term, DAE forecasts the annual pace of national retail spending growth over the next decade to slow to 3.3% per annum from 3.6% per annum over the last 15 years.

The national average retail vacancy rate (across regional, sub-regional and neighborhood centers) declined by 0.5 percentage points to 2.7% in December 2016, from 3.2% recorded in June 2016. It is now in-line with the 10-year long-term average.

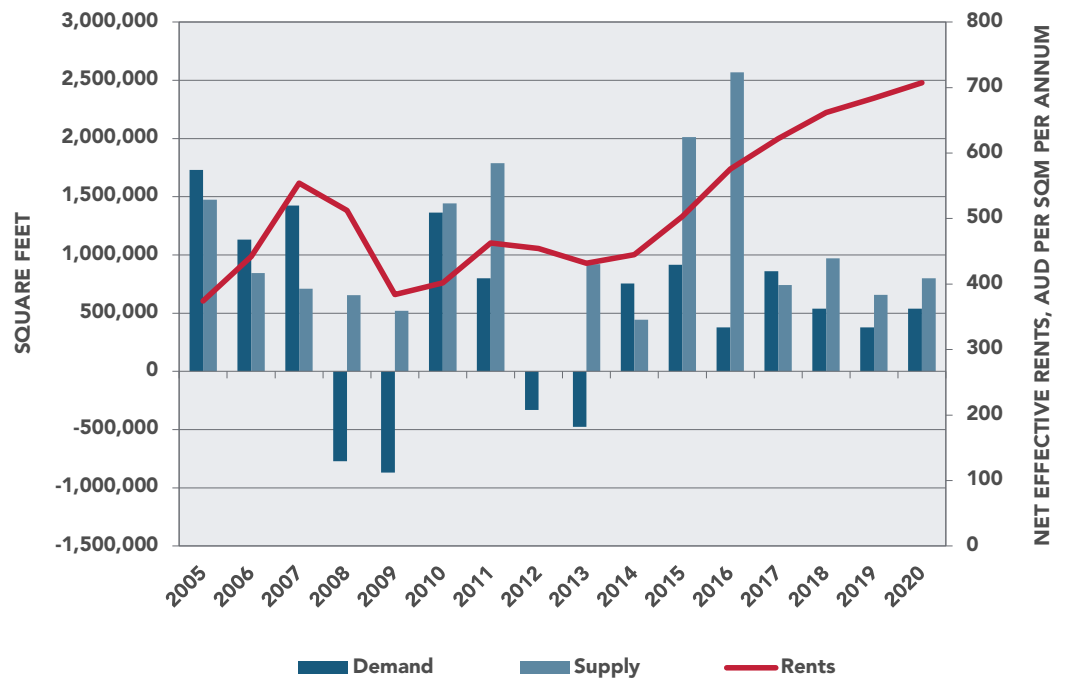
Shopping managers continue to enhance the tenant mix where possible, by capturing new trends in the retail industry to drive customer foot traffic. There has been an evident increase in food retailers particularly in regional centers. Many centers are upgrading their dining precincts and there has been a blurring of the lines between fast and slow food.

Melbourne recorded the highest rate of rental growth on average across all the sub-sectors, at 1.3% per annum as at Q4, followed by Sydney at 0.9% per annum. The performance of individual centers varies significantly, suggesting some centers may face limited rental growth in the short term. This divergence has contributed to the uplift in development activity in the last few years as landlords upgrade existing centers to reduce downside risk to rents and/or drive an uplift.

Investor demand for core retail assets has remained at a very high level. However, investor demand for secondary grade assets softened in 2016. Many institutional owners remain focused on improving portfolio quality in the retail sector, through tactical disposals or selective acquisitions.

Income growth will be the driver of capital values rather than yield compression, as yields stabilise through 2017. Primary retail fundamentals (demographics, competition and future supply) will be more important drivers of investment returns.

SYDNEY CBD DEMAND, SUPPLY AND RENTAL OUTLOOK



Source: JLL

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