Invesco Real Estate Asia

Cheng-Soon Lau, managing director–Asia, joined Invesco Real Estate in January 2006 and has overall responsibility for the management of the Asian real estate business. In the past 16 years, Lau has held senior management roles in the Asian real estate investment business. He has directed numerous real estate investment and development projects across all major markets in the Asia Pacific region and transacted more than $1.7 billion of real estate across the markets in Australia, China, Hong Kong, Japan, Indonesia, Singapore and Thailand.

Rita Ling is the client portfolio manager at Invesco Real Estate responsible for Asia. She develops and manages client relationships with a focus in Asia, and represents real estate investment activities to Invesco's diverse global client and consultant base. She has nearly 20 years of real estate experience.

Recently, Geoffrey Dohrmann, publisher and editor-in-chief of The Institutional Real Estate Letter – North America, *spoke with* ***Cheng-Soon Lau*** *of Invesco Real Estate. The following is an excerpt of that conversation.*

What is happening in the Asian markets?

The primary markets — Japan, which is predominantly Tokyo; China, led by the first-tier cities; Hong Kong and Singapore — have recovered perhaps with the exception of the office market in Japan. The distress that was expected, particularly in Japan with the maturity of large amounts of CMBS loans, has not materialized. However, we could see some downward pressure on the Tokyo office market as rents have rolled down and more loans come due.

Why did the expected distress not materialize?

The stance of the government, as well as of the banks and financial institutions in Japan, has had a major effect on keeping things calm. The banks stepped up to refinance or restructure some of these loans, allowing the owners to dodge the bullet in terms of having to sell under pressure. This is evidenced by the fact that although a large number of loans mature next year, we haven't seen a flood of real estate coming to the market looking to avoid that maturity date. I think the banks learned during the crash of late 1990s–early 2000s, that when they all rush for the door, the only thing that happens is that values implode. Today, there has been a lot more support in terms of trying to manage the exits.

Do you see an opportunity evolving in Japan as some of this more distressed weighted paper comes to market?

There is still some paper to work off in Japan, but I don't think the story will be clear until after the end of perhaps the first quarter this year. We have seen a few more so-called distressed properties come into the pipeline in the last couple of months, and there is the possibility that the pipeline will continue to grow as we enter the first quarter. The lack of transactions makes forecasts difficult. It was very quiet in 2009, as it was in 2008. There were only two big deals in Japan in 2009. One was the sale of the AIG Building, the second was the recent sale of the DaVinci-owned building, called Pacific Century Place.

How far were they off peak pricing?

For the AIG deal, it is hard to just use the numbers that the deal was struck at because there is redevelopment potential in that site. Based on redevelopment potential, the deal was probably done at about a 30 percent discount off the peak. For Pacific Century the discount would be somewhat similar. Vacancies have risen quite significantly in this area and rents have rolled down, hence that level of discounting is expected.

What is happening in the other countries?

The term "recovery" is different in each country. The Chinese market, particularly in the first-tier cities, didn't really go through much of a correction. When you look back on deals that were struck in the past couple of years in the residential market, you won't see a major pull back in prices. The few markets that did see some reduction in prices came back very strongly throughout 2009. In fact today, the luxury residential market has, in some cases, scaled new highs. The residential market is driven by increased wealth, demographics, and the fact that the government has provided liquidity early in 2009 to offset the financial crisis. In contrast, the office markets in the first-tier cities of China have seen a whole lot more supply. Rents are under pressure and depending on how much of the pipeline of new projects comes through, we could see the pressure on the office market continue. Tenants will have more choice, and the lower-quality buildings, even though they may have good location, will suffer from downward rent pressure and rising vacancy.

What is happening in Hong Kong?

The luxury residential market in Hong Kong has caused some concern as prices have continued to escalate. There is a lot of liquidity in the market without much new supply. Hence, the upward pressure on price. Investors have also been getting very attractive mortgage financing. This has prompted the authorities to cool the market down by raising the down payment requirements on residential properties. There is growing demand from Mainland Chinese investors and they constitute over 10 percent of demand at this point of time. The office sector has not been bullish, particularly in the secondary locations where there is ample supply. In general, the prime office market has good fundamentals due to the lack of new supply. However, investors may find sourcing good deals more difficult as liquidity in Hong Kong is high; domestic investors are well capitalized and funded. There is a lot of money looking at deals, so it makes the environment more difficult for investors, especially if they are looking for higher returns.

And that brings us to Singapore.

Singapore has seen a sharp rise in home prices despite the fear of oversupply in the residential market. The residential market has recovered, driven initially by demand at the lower-end of the middle market. When prices came off in late 2008 and early 2009, home buyers and investors believed that they had an opportunity to buy at a lower price and many of them returned to the markets. The luxury end of the market could still face more supply and the recovery in this segment, while under way, may take longer. The office market in Singapore continues to see high vacancy and rent roll downs.

What should investors look out for in the PRC?

Some developers are rushing to buy sites for development, particularly residential sites, at prices for the land that equate to the finished residential product in the surrounding area. The Chinese call this paying more for the flour than the bread. Therefore, investors should be cautious. There are opportunities for investors to invest in the PRC market without overpaying for land. Some domestic developers are already wary of overpaying for land. Investors should look outside the public auctions for opportunities and avoid overheated segments.

Where do you see the best opportunity to make money in 2010?

I would focus on the PRC in both the first-tier and some of the selected second-tier cities. The middle-range for-sale residential market is still attractive as it benefits from strong underlying demand. The top end is clearly much more fickle and is looking relatively expensive and, therefore I think a bit riskier. There are opportunities in this market, but it does take more work to develop deals. We think there will be a reasonable pipeline for investors in the coming year.

How about outside the PRC?

We like the office market in Japan. You are not going to get the same kinds of returns as residential development in China, but then again, you will have the prospect of getting some income. The Tokyo office market potentially offers an attractive return for investors over a five-year horizon. We don't necessarily think it has to be in the prime, grade A segment of the market. Tokyo has many well located class B buildings that could offer quite attractive economics. The multifamily market has also come back. It was beaten down in 2008, but recovered in 2009.

What are some of the key factors managers need to look for to operate in Asia?

A strong local team with market knowledge and the ability to execute the strategy is crucial. This team needs to have strong relationships with local authorities, financial institutions and the local industry. They should also be experienced across the cycle. Some of the problems we have seen in Asia have been related to a young market. For example, in the PRC, many in the industry have only really experienced an upswing.

What do you think are reasonable expectations for returns?

Through the mid-2000s in the PRC, return expectations were very high. If you were an early investor, it was not uncommon to see returns on an IRR basis well over 50 percent. One could achieve multiples of 3x or more in the early to mid-decade. Today, because the markets are maturing and there are a lot more players, it would be more reasonable to look at a 20 plus percent number in China, but it does take hard work to source a deal that gives you that return. A B-office strategy in Tokyo should deliver a mid-teen return.

How do you expect returns to evolve over the next few years?

I think returns will be more moderate but should remain attractive assuming economic growth continues albeit at a lower pace. In addition, in the PRC, investors could continue to achieve attractive returns by moving to the second-tier or third-tier cities as these cities develop. Also, as the markets mature, there will be more value-added opportunities, such as refurbishing well located existing buildings, that will allow investors generate attractive returns.

What are first-time investors in Asia concerned about?

Transparency is a major concern but this is improving. There is also a concern that some managers may have relatively short track records. Investors should also be concerned about the size of the fund being raised relative to the size of the markets. The issue will be the ability to deploy capital as well as exit expediently — particularly for a high-return strategy. I believe smaller funds are more suitable for such strategies in Asia. As with all investment, it takes experience, discipline and a deep knowledge of the markets to achieve attractive consistent returns. Asia offers a growth story and a variety of opportunities not found in many other areas of the world. Investors who can apply these strengths across the diverse Asian markets will benefit from the growth and opportunities in Asia. ❖

CORPORATE OVERVIEW

Established in 1983, Invesco Real Estate manages $25.6 billion (as of 9/30/09) of real estate investments in both direct property and real estate securities. With 224 employees in 13 offices worldwide, the group focuses on top-down market and property type fundamentals combined with bottom-up local market intelligence. Senior members of the management team have worked together for 22 years, contributing to the consistent implementation of Invesco's investment strategy and resulting performance.

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