

A New Force in Asian Real Estate: Indigenous Demand

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Research

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Asia as a recovery play is easy to grasp: attractive valuation is now supported by growth. In fact, the region is projected to lead the world in economic growth. China heads the pack with a forecast 2004 GDP expansion of 7.8%. Relentless deflation – more than a decade in Japan and more than six years in the rest of East Asia after the financial crisis in 1997 – has brought most real estate to its cyclical trough. Tokyo's commercial property values, for example, have plummeted by as much as 85% since their peak in 1987 (see **Exhibit 1**). Yet, value can be found, and nascent signs of recovery are starting to emerge in a few big Asian property markets, notably Tokyo, where office yields have been falling, and Hong Kong, where demand for prime office space and luxury housing has been rising since the second half of last year.

This may smack of déjà vu to investors who pursued opportunistic recovery plays in the immediate aftermath of the Asian crisis. Then, sharp cuts in interest rates fuelled such quick spikes in valuations that “opportunistic” deals vanished equally quickly. The subsequent collapse of the Internet and technology bubble in 2000, in turn, pushed many of the export-dependent Asian countries into recession. Their real estate values slumped again after a brief but sharp rebound.

So what makes a recovery this time around different? The US is showing more encouraging signs of a turnaround, and the Asian economies should, therefore, recover in tandem. We recognize the risks associated with the twin US deficits, but tacit in this report is the assumption that the US economy will not falter and drag export-dependent Asia into yet another recession. Even so, Asia is not homogenous; recovery and growth prospects would not be uniformly upbeat. We are, therefore, not advocating Asia as a blanket opportunistic recovery play. The region – thanks to depressed real estate values and more robust economic prospects (relative to the rest of the world) – offers a yield-plus-growth play. This should appeal to those Western investors trying to circumvent generational low interest rates and near-peak real estate cycles in their home markets.

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Exhibit 1: Price Declines Since the Peak

	Peak	Latest	% Change
Tokyo			
Metro Avg.	Sep-87	Sep-03	-79%
Commercial	Sep-87	Sep-03	-85%
Residential	Sep-87	Sep-03	-76%
Hong Kong			
Office: Central	Jun-94	Dec-03	-66%
Residential	Jun-97	Dec-03	-56%
Retail	Sep-97	Dec-03	-56%
Singapore			
Office: Central	Sep-96	Dec-03	-53%
Residential	Jun-96	Dec-03	-38%
Retail: Central	Sep-96	Dec-03	-41%
Korea *			
Seoul: housing	Oct-03	Oct-03	0%

Source: CEIC

Although the “buy China” theme is obvious, we have reserved that discussion for a later forum. In this report, we will focus on the more developed East Asia – Japan and the Asian Tigers¹ of South Korea, Hong Kong and Singapore. Here, the need to balance value against sustainable growth is especially important. Sustainability of growth hinges on the ability to overcome two structural trends: hollowing out caused by a very competitive China and India² and population aging, as well as a recovery in the world economy.

Despite these challenges, good opportunities remain for property investors, especially for indigenous Asian investors who are looking for yield arbitrage. We see three trends: 1) Attention to value is important as the buy-for-a-quick-flip strategy is risky, given that the pace of recovery is projected to be slower than the blistering growth of the 1980s and 1990s; 2) Restructuring is deepening and, as a result, is spinning off more deal flow and real estate investment trusts (REITs). In the process, greater market discipline will usher the paradigm shift toward a more yield-driven market; 3) A growing indigenous pension industry will underpin the long-term demand for long-duration assets, such as bonds and real estate. This emerging source of domestic demand will be foreign institutional investors’ main competition in the bid for assets. We suspect more Asian funds have already been making their way home to hedge against the possibility of a delinking of their currencies from the greenback. Asian currencies are now pegged, to different extents, to the US dollar. Besides the outright pegs of the Hong Kong dollar, Chinese renminbi and Malaysian ringgit, most of the other Asian currencies (except the Japanese yen) are still loosely tied to the greenback.

Restructuring and the Growth of REITs

Strong foreign direct investment (FDI) flows funded the Tigers’ economic boom of the 1980s and early 1990s. Hong Kong and Singapore particularly relied on FDI, which averaged 11.5% and 9.7% of their respective GDPs since 1990. But the Tigers have started to lose their roar as China has been cannibalizing FDI. With a loss of FDI comes loss of production, jobs and growth. The Tigers’ painful adjustment to an economically more menacing China accelerated in the late 1990s. Such structural adjustments were further exacerbated by a cyclical downturn in

¹ Taiwan is one of the four Asian Tigers. Although we also refer to Taiwan when we discuss general economic issues concerning the Tigers, we exclude it in specific discussion because the country is not currently within our coverage universe.

² While India is also not currently within our coverage universe, we are interested in examining it more closely in the future.

the last two years due to a slowdown in the US. To counter waning FDI, the Tigers need to unlock capital trapped in their frozen asset markets to fund regeneration and growth.

Unlike the Tigers, Japan's economic woes were caused by more than a decade of deflation, which caught the country in a liquidity trap, making further monetary policies ineffective, as interest rates had already been reduced virtually to zero. Japan, too, must unlock domestic savings to lift the country out of its quagmire; a large part of the solution is a massive cleanup of its banks, which are laden with nonperforming loans (NPLs).

However, both Japan and the Tigers are showing signs of bottoming out. As their economies improve, corporate restructuring will likely pick up steam as the export-dependent Tigers start to recover, in tandem with a rebound in the US economy. Restructuring should quicken as the return of demand helps thaw the previously frozen asset markets. As the asset markets begin to clear, long-suffering bankers and shareholders stuck with poor loans and investments can begin to liquidate their NPLs and unprofitable projects. Some highly leveraged businesses that need fresh capital to upgrade, expand or invest in new businesses currently find it difficult to access new loans from banks and/or additional capital from shareholders. Conditions are now more conducive for them to start divesting assets to raise cash.

In Japan, the strong pressure for ailing banks to tackle their massive NPLs continues. Government debt weighs in at 150% of GDP, the highest in the developed world. With fiscal deficits ballooning, the Koizumi government must start withdrawing handouts from unproductive businesses that survive purely because of subsidies. Although banks have been tardy in getting rid of their NPLs and repairing their balance sheets, more disposals have occurred via the Japan REIT (JREIT) market, which debuted in 2001. These trusts have been the main dealmakers, marrying financially troubled vendors with aging savers, whose alternatives are mostly near-zero returns on their savings and 1.5% on 10-year government bonds. For foreign direct investors, the window of distressed sales, which opened in the last two years, is beginning to close as JREITs dominate acquisitions.

Elsewhere in Asia, portfolio restructuring is also gaining currency among Asia's listed conglomerates and real estate players. They are motivated to shed lumpy and capital-intensive commercial assets in a bid to raise their overall ROEs. In their current state, many have little relevance to equity investors; they are neither growth stocks (as they were when asset inflation was rampant in the early 1990s) nor dividend plays (their mixed business model subsidizes capital-hungry property development with cash flows from rented properties). Their disfavor with investors is most clearly borne out by their shrinking representation in local stock exchanges. In Hong Kong, the listed property companies' share of total market capitalization has more than halved from 29% in 1996 to 11% in 2003 (see **Exhibit 2**). In Singapore, listed property companies accounted for a mere 5% of the local exchange's market capitalization in 2003, down sharply from 40% in 1990. Concomitantly, their market-weighted representation in MSCI indexes and, therefore, their significance in indexed funds have shrunk as well.

Exhibit 2: Property Sector as a % of Total Market Cap

Year	Japan	Hong Kong	Singapore
1990	1.50%	26%	40%
1991	1.40%	28%	35%
1992	1.20%	27%	36%
1993	1.20%	26%	25%
1994	1.20%	28%	14%
1995	1.20%	26%	13%
1996	1.30%	29%	12%
1997	1.40%	27%	11%
1998	1.20%	19%	5%
1999	0.90%	18%	7%
2000	0.90%	14%	5%
2001	1.10%	14%	6%
2002	1.10%	13%	5%
2003	1.20%	11%	5%

Source: CEIC

Real estate in South Korea is not represented in the local exchange as a separate industry sector. Substantial real estate assets there are held by large “chaebols,” or conglomerates. In the aftermath of the Asian financial crisis, distressed sales were active in 1999 and 2000, as the chaebols and public entities needed to deleverage. Perhaps due to the association with “distress,” Korean companies have been reluctant to shed assets since then.

In the mean time, listed entities in Japan, Singapore and Hong Kong are pursuing asset divestment in a bid to raise ROEs. ROEs rise when “low” yielding but capital-intensive commercial assets are divested, and the capital is reinvested in core businesses that give returns exceeding hurdle rates. This is because most ROE targets for listed enterprises among the Tigers are higher than the single-digit yields generated by the commercial assets. As a result, most of these companies suffer negative economic value added – the single-digit yields plus the unrealized capital losses push their overall return below the weighted average cost of capital. Their stock valuation suffers because of their reputation as capital destroyers. In terms of cash flows, most of these Asian conglomerates and property players use rental income to subsidize cash flow needed elsewhere. This hampers their ability to pay dividends as high as REITs pay. These factors explain their fall from grace in the equity world.

The need to segregate assets to target them to different investing audiences gave birth to Asian REITs. Property players led the way by streamlining their office, retail and industrial assets and packaging them into REITs that appeal to yield-seeking investors. Since the first Asian REIT was launched in Tokyo in 2001, the REIT market has grown to about US\$10 billion in market capitalization, with JREITs accounting for close to 90%. Japan now has 11 REITs, Korea has seven (CR-REITs), and Singapore has three. Hong Kong tapped Singapore’s REIT platform to create its first REIT – Fortune REIT – last year.

The Asian REIT market looks set to grow. Singapore-based Capitaland is proposing to bundle S\$2 billion (US\$1.1 billion) of office properties into an office REIT. Also in the pipeline this year are 12 IPOs in Japan and possibly four in Singapore and Hong Kong – Mapletree (port and district parks), Malls of Centrepoint (malls owned by Fraser & Neave), China Resources (overseas REIT) and Hong Kong Housing Authority REIT (malls and parking garages).

Two Types of Demand: Opportunistic and Safe Haven

After the Asian financial crisis had done its damage to asset values, opportunistic investors descended on Asia to scour for distressed sales. South Korea, one of the worst hit by the crisis, saw a more active distressed sales market in 1999 and 2000 as the currency collapsed, domestic interest rates soared, and the real estate market tumbled. Seoul's office yields reached 12% to 13% in 1999, widening spreads to 350-450 bps. The market has since firmed, with initial yields easing back to 8.2% to 9.0%.

In Japan, relentless deflation in the 1990s had compressed bond yields, depressed asset values and widened yield spreads. But since 2000, Tokyo has seen a rush of opportunistic real estate transactions, thanks to attractive yield spreads (290-330 bps) and the formation of the Resolution and Collection Corp., an asset management firm that helps dispose of NPLs. Elsewhere in Asia, the benign interest rate environment after the Asian crisis kept fire sales to a minimum. Except during the technology bubble in 2000, when asset prices had a temporary reprieve, the asset market remained essentially frozen as buyers and sellers were caught in a stalemate.

Conditions in 2002 and 2003 favored Asian REITs – the economic outlook was uncertain, risk aversion was high, and interest rates were low. As the bond market is relatively undeveloped among the Tigers, REITs became the safe haven for equity investors and a godsend for savers looking for yield pickup from the paltry returns on their fixed deposits. (One-year deposit rates were as low as 0.1% in Tokyo and Hong Kong, and 0.7% in Singapore.) Domestic demand chased up share prices of JREITs and SREITs, causing them to outperform their domestic exchanges last year. Yield spread of about 300 bps in Japan remains attractive to domestic investors despite a rise in Japanese bond yields in 2H03, which explains the domestic institutions' continued demand for JREITs.

But REIT price appreciation has compressed yields. After a tentative debut in 2001, strong domestic demand has driven up JREIT prices and lowered yields from 5% to about 4.5% currently. Singapore's retail REIT, CMT, has risen more than 40% since its IPO in July 2002, and its dividend yields have shrunk from roughly 7.5% to about 6.5% currently.

Investment in real estate by domestic players yielded lucrative gains in the halcyon days of the early 1990s, when asset prices chalked up strong double-digit yearly appreciation fuelled by liquidity from more than two decades of brisk economic growth. But wilting deflation since the Asian financial crisis in 1997 has started to alter the mindset of Asian baby boomers who had, until then, been fed only on asset inflation. With much wealth destroyed by deflation, many aging baby boomers must rebuild their retirement nest eggs. As they do so, their investment paradigm will change: high-risk punts in the hope of quick gains are likely to give way to more prudent, less volatile investment options, such as REITs. This is because the pursuit of hefty capital gains will become more illusive as economic growth matures and populations age. Therefore, investors must rely more on recurrent yields to achieve total return targets.

A structural shift toward a long-term search for yields has already begun. The life cycle hypothesis states that the propensity to save is higher, in general, among people in their 50s facing retirement than among younger generations or elderly households. Given the aging profile of Japan and the Tigers, the savings rate is, therefore, likely to rise.

In the last six months, idle savings stuck in fixed deposits and bonds have started to become unlocked as deflationary pressures ease. The proverbial money under the mattress is being rechanneled from risk-free fixed deposits to arbitrage the positive carry offered by REITs. Statistics on household savings are hard to get, but the size of the market is huge, as Asians are voracious savers compared with Westerners (see **Exhibit 3**). The Tigers have an average gross national savings (GNS) of 36.6% of their 2002 GDP; Singapore's is the highest at 48%. Japan's GNS has been trending down due to its ballooning fiscal deficits. Even at 26.5% in 2002, Japan's savings rate is still higher than the 15% in the US.

Exhibit 3: Gross National Savings (% of GDP)

	2000	2001	2002	2003
Singapore	48.8	45.2	47.7	48.4
Hong Kong	33.6	33.8	34.9	36.0
Malaysia	36.4	32.1	30.9	NA
Japan	28.7	27.7	26.5	26.1
China	39.7	NA	NA	NA
Korea	31.3	28.8	27.3	NA
United States	18.4	16.5	15.0	NA

Source: IMF

Growing Asian Pension Industry to Drive Long-Term Demand

In the longer term, the next wave of demand for real estate will emanate from the indigenous pension industry, which is projected to grow as the population of the Tigers turns increasingly gray. Pension and insurance funds are likely to seek out annuities to better match their assets with their liabilities. The commercial real estate markets provide good sources of annuities, thanks to the underlying recurrent rental income. And in terms of total return over the long term, the experience of the REIT markets in the US and Australia has shown that REIT returns are not dissimilar to equity returns. However, the composition of the returns differs, with dividend yields accounting for most of the REIT returns. The role of Asian REITs as public conduits will grow significantly as they marry restructuring corporations needing fresh capital for renewal with domestic, investable funds from idle savings and the burgeoning pension industry.

Japan is already an aged society, with 19% of its population over age 65 (see **Exhibit 4**). Australia is a borderline aged nation, with almost 13% over 65. Hong Kong, Korea and Singapore are also aging fast; in about two decades, they too will be aged societies.

Exhibit 4: % of Population Over 65 Years Old

	2003	2008E
Japan	18.7%	21.3%
Australia	12.7%	13.5%
Hong Kong	11.0%	11.2%
Korea	7.9%	9.5%
China	7.4%	7.6%
Singapore	7.2%	7.4%
Thailand	7.1%	7.3%
Malaysia	4.4%	4.9%

Sources: EIU; Pricoa estimates

For those countries on Pay-As-You-Go (PAYG) pension schemes (e.g., Japan and Korea), concerns are growing that in about 20 years the work force may not be large enough to support the pension benefits of the bulging pool of retirees. The long-term solvency of the public pension systems hinges on some combination of cutting benefits and raising contributions, which is now being proposed in Japan. Continued skepticism about the viability of existing public pension schemes is also likely to spawn more private pension plans, in addition to lobbies for the creation of a reverse mortgage market.

Singapore and Hong Kong have mandatory pension savings schemes. But Hong Kong's system only began in 2001, with employers and employees each contributing a mere 5% of an employee's monthly salary. Singapore's scheme, which has existed for more than 30 years, is more substantive, with a contribution rate of 33% of a worker's monthly income. Even then, deflation has revealed a kink in Singapore's much-vaunted scheme. As a significant part of pension savings had been channeled to servicing home mortgages, a substantial portion of pension wealth has been destroyed with declines in home prices.

Building and growing pension savings has become a policy priority in Asia. Japan is already in the midst of trying to reform its pension system and is leaning toward increasing the pension premiums to meet the needs of longer life spans. The paternalistic Singapore government has just proposed to "privatize" pension savings, allowing the funds to be privately managed. It has become increasingly clear that the 2.5% to 4.0% that the Singapore government guarantees on pension savings are unlikely to see retirees through their twilight years. As of September 2003, close to S\$70 billion (about US\$40 billion) of such forced pension savings remained uninvested.

Conclusion

Asia as a recovery play has become an accepted mantra as the regional upturn becomes more evident. Investment interest is intensifying, having morphed from an opportunistic play to a safe haven over the last five to six years. But going forward, indigenous pension funds are likely to play a bigger role in the demand for real estate. For Western institutional investors looking to diversify into Asia, domestic investors will be the key competitors for assets.

Falling yields in Asia pose a challenge for international investors who need to meet higher hurdle rates. They also make the investment playing field less level, as domestic funds benchmarked against lower hurdles become more competitive in the acquisition arena. The Asian real estate investment scene is, therefore, expected to become more active as intraregional arbitrage increases. Monies from lower-yielding areas, like Singapore and Japan, are likely to be re-deployed to acquire assets offering higher returns in markets such as South Korea and even in developing countries like Thailand and Malaysia.

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