In This Report

Economic conditions and leasing fundamentals are buoyant across the region. Rents are rising in developed office markets, supported by low supply growth. Declining flows of capital from China are a concern, though transaction volume and pricing are holding up. Income growth is playing a greater role in capital value movements, and investors are taking more style and location risk. The focus of investment opportunities is on the office sector, which offers scale for core and value-add strategies, and, for longer term investors with higher risk preferences, fast-growing emerging markets.

In terms of opportunities we highlight the following investment strategies:

- **Seeking Growth in Office**
  Strong employment growth continues to support robust demand for office across major developed and emerging markets.

- **Active Asset Management**
  Active asset management is becoming a more critical driver of growth as occupier markets are evolving rapidly.

- **Looking Beyond Established Markets**
  Finding values and secular growth in new markets and sectors that offer structural demand for real estate beyond the short term leasing cycle.
Solid Real Estate Fundamentals

Economic conditions remain mostly buoyant across the Asia Pacific region. GDP growth was better than expected in 2017 and business sentiment and consumer confidence readings point to favorable ongoing momentum. Economic expansion is being driven by domestic demand growth – underpinned by rising consumption and corporate investment spending – and intra-regional trade activity.

Across Asia Pacific’s real estate markets, leasing fundamentals remain mostly favorable, reflecting the positive economic backdrop. In the office sector, major Asian markets continued to see healthy broad-based occupier demand, driven by strong employment growth, notably among financial and technology occupiers.

The most rapid increase in take-up is being recorded in markets such as Shanghai, driven by take-up by multinationals in decentralized submarkets, along with Osaka and Singapore, where corporate occupiers are expanding. Among other major markets, Tokyo and Sydney are seeing slower activity, although demand remains firm and leasing is being held back by a limited supply of available space, as office vacancy is low and many projects under construction are fully pre-leased.

EXHIBIT 1: ASIA PACIFIC OFFICE RENTAL GROWTH

![Diagram showing rental growth trends in various cities in the Asia Pacific region.](https://example.com/diagram.png)

As a result, rents are rising across major office markets and the range of rental growth is shifting gradually upwards to its best position since 2011 (Exhibit 1). Except for a few markets – such as Brisbane and Shanghai, which have high vacancy rates, or Beijing CBD or Jakarta where the pipeline is significant – demand is set to outpace supply, pointing towards broad-based rental growth prospects for office markets across the region.

Outside the office sector, consumer sentiment and household spending remain buoyant, supporting demand in retail and logistics sectors. However, as with other parts of the world, both sectors are undergoing structural changes.

Sources: JLL, PGIM Real Estate. As of May 2018.
Owing to the strong growth of e-commerce, total take-up of logistics space in Asia has tripled to about two million square meters per year over the last five years. As growth of online sales continue to outpace spending in physical stores in most parts of the region, demand for logistics is likely to remain strong, supporting rental growth – particularly in China, Australia and South East Asia, although Tokyo is weakened by a significant increase of new supply expected in the near term.

Under pressure from the secular rise of online spending, the retail sector performance remains polarized. Medium sized, sub-regional malls are struggling, while footfall, occupancy and rental growth are holding up relatively well in CBD and tourist-driven retail locations.

**Investment Activity Holds Up Despite Slowing Chinese Capital Outflows**

Investment activity is holding up across Asia Pacific, reflecting a sense of optimism about the outlook for the economy and occupier markets. Despite concerns that capital controls in China will dampen investor sentiment, transaction volume of income-producing assets – a measure that excludes land sales – rose 10% to reach $150 billion in 2017, although the composition of players and target markets is changing (Exhibit 2).

Asian investors remain active. Domestic capital sources remain dominant, but intra-regional investment spending – capital flowing across borders, but within Asia Pacific – rose by more than 30% for the second year in a row in 2017. While large developed markets, such as Australia and Japan, continue to attract a significant share of capital, interest is growing most quickly in higher growth markets. Capital inflows recorded by South East Asian nations have doubled over the past year.

In contrast, global investors – predominantly from Europe and North America, which typically account for just under a fifth of the investment market – became less active. Sydney, Melbourne, and Tokyo remain among the top Asia Pacific cities attracting global capital inflows marking a clear diversion with intra-regional capital, as cross-border Asian investors are shifting their focus to Singapore, Hong Kong and Shanghai.

While capital continues to flow into China, capital controls imposed to restrict outflows in late 2016 are starting to affect activity among its overseas investor base. Net acquisitions by Chinese capital sources in the Asia Pacific region have declined by almost 50% since peaking in mid-2016 – although China- and Hong Kong-based investors remain highly active in the European market.

As the Chinese government builds pressure on financial organizations to improve their balance sheets and reduce financial risks, there are concerns that widespread action could trigger a sharp wave of foreign asset dispositions. However, for the time being, only a handful of corporates are showing an increased level of stress and the amount of assets being put on sale remains small.
The buoyant economic outlook and positive momentum in occupier markets across the region is supporting sentiment, and investment activity is set to remain steady in 2018. However, availability of stock and elevated pricing continue to be a barrier limiting both the volume and speed of transactions.

**Yield Compression Cycle Set to End**

For real estate investors in the region, borrowing costs are starting to edge upwards, although the extent of future interest rate increases remains uncertain. While central banks across Asia Pacific are set to respond to recent tightening by the U.S. Federal Reserve, a lack of inflation pressure allows a degree of flexibility in several countries, particularly in Australia and Japan where rates are set to stay on until at least 2019.

Even so, bond yields are forecasted to follow the United States to some degree, rising from about 2% across developed markets at the end of 2017 to 3% over the next five years (Exhibit 3). At the same time, steady yield compression in recent years means that prime property yields are at or close to historic lows in most major Asia Pacific markets.

The improved occupier market outlook is pushing up income growth expectations, helping to preserve the risk premium on offer – but there are signs that the pace and scope of yield compression is slowing. The number of markets recording yield compression fell across all major sectors during 2017.
History suggests that some further yield compression is possible, as interest rate tightening cycles are associated with an improving economic environment and strong rental growth prospects. However, the starting point for yields is normally much higher than today and investors are increasingly cautious on pricing, particularly in low-yield markets.

**Growth to Drive Capital Values**

Real estate fundamentals are set to become a more significant factor driving capital growth across Asia Pacific. Over the last few quarters, rental growth is gradually becoming a larger driver of capital growth, its impact in the office sector rising from 2% at the end of 2016 to 3.1% by the end of 2017 (Exhibit 4).

An anticipated shift away from yield-driven capital value movements represents a return to a more typical environment. Between 2000 and 2014, yield impact played a lesser role – with capital value growth driven mostly by rental growth. In the last three years, rental growth has been more modest, leaving value growth driven largely by declining yields across the region.
As yield impact diminishes, performance of fundamentals is set to be a key determinant of market performance, something that is already happening in late-cycle expansion markets, such as Brisbane and Osaka, where ongoing rental growth is the primary driver of strong return expectations given their already narrow yield spreads against major gateway markets.

In several office markets, growth prospects are aided by very low development rates. Apart from Tokyo and Beijing, most major markets are expecting new supply to be significantly below its 10-year average, as a lack of development sites and tighter bank lending conditions are limiting construction activity across the region. Leasing conditions are set to remain favorable for landlords, boosting rental growth prospects and potential for capital value uplifts.

There are other sources of growth potential too. Infrastructure investment – in the form of street pedestrianization in Sydney, new subway lines in Singapore and Seoul, or expansion of high speed rail network in China – offers a source of growth potential via a re-rating of sub-market rents owing to better connectivity and, potentially, higher-value land uses. Suburban retail in Singapore, decentralized office markets in Shanghai and Seoul, and office and industrial assets across Sydney are well-placed to benefit from infrastructure upgrades.

**Investors Taking on Style and Location Risk**

Current market conditions are characterized by a combination of improving occupier conditions and resilient investor sentiment, yet also by low yields and a declining yield impact on capital values. Investors are finding it increasingly challenging to source and underwrite core stabilized asset deals, which carry substantial downside risks if future growth turns out lower than expected, or if interest rates rise rapidly.

EXHIBIT 4: CAPITAL VALUE GROWTH – ASIA PACIFIC OFFICE

Sources: JLL, PGIM Real Estate. As of May 2018.
Instead, investors are shifting their focus to finding value in core plus and value-add strategies, seeking to create value through active asset management to improve and increase cashflow. According to ANREV, core is now the preferred style of just 26% of investors – compared to more than 40% over the past three years – while 50% expressed a preference for value-add strategies in 2018 (Exhibit 5).

EXHIBIT 5: INVESTMENT PREFERENCES AND ACTIVITY BY MARKET TYPE

Another factor supporting a shift in preferences towards value-add investing is that evolving occupier trends are demanding more intensive asset management than previously. In the retail sector, pressure from the growth of online retailing intensifies requirements for refining the offering to attract shoppers and improve customer experience. Polarized asset performance in the retail market implies an opportunity for skillful managers to benefit from turning around performance of under-managed or “under-threat” assets.

In terms of markets, similar trends are pushing investors towards smaller markets. The share of capital going to major gateway markets – notably Tokyo and Sydney – is falling. In contrast, regional cities like Nagoya in Japan, and Brisbane in Australia, are gaining share, owing to higher yields relatively favorable cyclical momentum on the occupier side.

Investment Opportunities

With the yield compression cycle coming to an end, and income growth set to be the main driver of capital value appreciation in coming years, real estate investors across Asia Pacific are broadening their search for new sources of return.

In a fast-growing region like Asia Pacific, investors stand to benefit from an investment approach that combines top-down market selection with bottom-up asset picking to enhance the risk-adjusted return outlook for their investment portfolio.
An improving outlook for economic and real estate leasing market fundamentals should support a further shift in risk appetite, away from a strong focus on pursuing high quality, income-generating assets in core locations towards enhanced-return opportunities in smaller markets, and value-add strategies.

1. Seeking Growth in Office

Strong employment growth continues to support robust demand for office across major developed and emerging markets.

Over the last few years, the office sector – which accounts for about half of the Asia Pacific investment market – has recorded relatively strong rental growth in comparison to other sectors. In general, the retail sector is struggling to generate rental growth – despite some segments such as regional retail in Singapore or high street and tourist-driven retail in Japan and Australia continuing to do better than the sector average. And while there are opportunities in logistics, it is still a small sector, accounting for just 10% of the investment market. The broader base of outperformance in offices implies a deeper opportunity set for investors in this cycle.

Looking ahead, rising employment and an ongoing recovery among key occupiers points a further expansion of office demand. At the same time, supply growth is still moderate – deliveries are set to remain below their 10-year average apart from in Beijing CBD and central Tokyo – and rental growth momentum is set to continue (Exhibit 6).

Among the more attractive markets are late-cycle expansion markets, such as Singapore, along with Brisbane and Osaka, which have almost no new net supply penciled in over the next three years. There are prospects for further rental growth in Sydney and Melbourne, owing to highly favorable fundamentals, although affordability in these markets is starting to look stretched as effective rents have grown to almost 40% above the pre-global financial crisis peaks in both markets.
As grade A availability declines in relatively high-rent CBD areas, there is an opportunity for higher-yielding fringe and smaller decentralized submarkets to attract occupiers that are seeking more affordable options. The growth in scale of some decentralized markets – such as Sydney’s North and Paramatta suburbs, and Melbourne’s Docklands – is attracting tenant interest, while strong returns performance appeals to investors.

Similarly, submarkets in greater Tokyo, decentralized Shanghai and Hong Kong’s East are looking attractive with improved fundamentals and a favorable rental growth outlook.

**2. Active Asset Management**

Active asset management is becoming a more critical driver of growth as occupier markets are evolving rapidly.

Active asset management – the process by which real estate owners receive, modify and grow the income streams associated with their buildings – has always played an important role in optimizing performance. Given the rapidly evolving nature of occupier markets – linked to factors such as accelerating technological advancements and shifting preferences among younger workers – the importance of successful asset management is growing.

The retail sector is an example. Just a few years ago, the market was focused on how traditional retailers could ward off competition from e-commerce. Today, most retailers consider omnichannel strategies as the way forward, in most cases implying lower physical space requirements than would otherwise be the case. Yet
online retail platforms are increasingly opening physical stores, blurring traditional lines and demonstrating that retail asset owners need to actively respond to ongoing changes in retailer business models and consumer shopping habits.

Performance varies across individual markets, even for asset types previously thought to be resilient to e-commerce disruption, such as convenience stores or tourist-driven high street retail. In contrast to Tokyo’s Ginza and Omotesando districts, where tourist-related demand has held up, retail malls in Orchard Road in Singapore are faring less well. There is a similar contrast between suburban retail malls in Singapore, which are recovering, while sub-regional retail in Australia is struggling.

The complexity of the retail market environment across markets in Asia Pacific indicates higher risks but, at the same time, also implies a broad opportunity set for asset managers.

Similarly, office and logistics asset owners are finding that the needs of occupiers are becoming more sophisticated. Competition for office tenants, for example, is no longer just about pricing, asset quality or location – factors such as workplace “ecosystems,” along with flexibility of lease terms and space configuration are growing in importance.

Such trends imply risks and opportunities for investors. While older or poorly managed buildings are at greater risk of underperforming, there is an opportunity for skillful managers that can acquire under-managed assets, often at discounts, and actively improve, reposition, or repurpose them to enhance performance and achieve higher returns.

One sector that is being overlooked by investors globally is secondary retail. Across Asia Pacific, spreads between prime logistics and secondary retail assets have risen to their highest level in a decade (Exhibit 7).

**EXHIBIT 7: OPPORTUNITY TO FIND VALUES AND BOOST RETURNS VIA ACTIVE ASSET MANAGEMENT**

Sources: Cushman and Wakefield, JLL, PGIM Real Estate. As of May 2018.
While there are risks to the retail outlook, retail sales are growing rapidly in most parts of Asia thanks to rising city populations and real income growth. The lack of interest from investors in recent years has kept a lid on the supply pipeline, especially in markets like Singapore, Melbourne or Sydney. This offers an appealing opportunity for investors to acquire and reposition well-located, but underperforming its potential, assets to boost performance and valuation of the asset as a result.

### 3. Looking Beyond Established Markets

Finding values and secular growth in new markets and sectors that offer structural demand for real estate beyond the short term leasing cycle.

Across Asia Pacific, the era of low interest rates and quantitative easing provided an abundance of capital and liquidity – much of which focused on major asset types and locations, driving yields down to historic lows. Until recently, real estate investors had considered gaining exposure to lower risk, higher quality assets as the preferred route to deploy capital. Investors have maintained discipline in the use of leverage, and broadly limited their activity to a limited few mature markets that offer liquidity, transparency and generally lower risk premium.

With economic growth becoming more broad-based across markets in the region, investors with higher risk tolerance are increasingly ready to look beyond established markets in their search for assets with growth potential and attractive returns.

New sectors are arising as real estate markets go through significant structural changes. For example, technological progress, demographics shifts and the ongoing rise of production capabilities are prompting a sharp increase in demand for data centers and senior housing.

More broadly, the Asia Pacific economy is forecast to account for 50% of global growth and 60% of the increase in global middle-income population in the next decade. As the regional economy becomes less dependent on exports to other regions and economic development continues, commercial real estate opportunities in emerging markets are set to grow.

Over the last decade, several markets and sectors in Asia have successfully transformed and matured alongside economic and financial market development. One example is Seoul’s office market, in which investors have benefited from structural changes as the market has become more institutionalized, offering more transparency, higher liquidity and lower risk premium. China’s tier 1 cities are now demonstrating a similar path of structural progression.
New emerging markets, including South East Asian nations and India, are currently experiencing rapid economic growth, supporting deeper financial markets and boosting private wealth (Exhibit 8).

As economic development progresses, growth in demand for residential and commercial real estate as capacity in services and consumer sector increases is set to drive an expansion of the built environment, moving beyond basic needs such as affordable housing and retail.

In the office sector, for example, annual net absorption of grade A office space in major emerging cities including China and India has doubled to 1.6 million square meters over the last five years – almost three times bigger than the aggregate of net absorption in developed Asian markets.

The risks of investing in emerging markets or sectors are tied to opportunities, including lower asset quality, a lack of liquidity and higher market volatility. However, buy-and-hold investors are well-positioned to benefit from further structural improvements over time.
Global Map of Investment Opportunities

**Niche Sectors**
Increased investor interest in non-traditional property types goes beyond a search for higher yields as many also offer stable and growing income streams.

**Suburban Apartments**
The opportunity in the apartment sector is evolving towards better performing class B, suburban assets with walkable amenities and good transit access.

**Accommodation and Living**
Supportive structural trends point towards ongoing opportunities in accommodation and living, including in hotels where occupancy is rising.

**Value-Add Equity and Debt**
Given a lack of grade A space in the office pipeline, strategies that seek to “create core” remain attractive, along with selected developments.

**Seeking Growth in Office**
Strong employment growth continues to support robust demand for office across major developed and emerging markets.

**Logistics**
Consumer demand is evolving rapidly and logistics rents are rising, pointing to investment opportunities across the Americas and Europe.

**Looking Beyond Established Markets**
Finding values and secular growth in new markets and sectors that offer structural demand for real estate beyond the short term leasing cycle.

**Active Asset Management**
Active asset management is becoming a more critical driver of growth as occupier markets are evolving rapidly.

**Debt Strategies**
Depending on risk preferences, debt instruments offer an attractive risk-return trade-off in weaker market conditions.

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**Nature of Opportunity**
- Market-Level
- Active Management
- Structural Trends
- Value Sectors and Locations

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Excerpt from the May 2018 Global Outlook
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