Investment case: Asia Pacific core real estate

The Asia Pacific (APAC) real estate market has grown into the largest in the world, offering increasingly high levels of maturity, transparency and liquidity. This has created a wide and attractive universe of core real estate opportunities in a region once dominated by opportunistic investors.

Institutional investors can now benefit from Asia’s strong economic growth, achieve sustainable long term returns and increase risk adjusted portfolio performance without going higher up the risk curve. Asian real estate has come of age, earning itself a strategic place in diversified core real estate portfolios.

### Why Asia?
- Exposure to a diversified and maturing region which accounts for a third of the world’s economic output and offers a sustainable growth premium over the US and Europe.
- Diversification benefits. An allocation to Asian real estate boosts risk-adjusted returns as part of a global property portfolio; plus there are diverse opportunities within Asia itself.
- Defensive characteristics, with underlying occupier demand supported by robust economic fundamentals, as showcased by Asia’s resilience during the European and US downturns of the recent financial crisis.

### Why now?
- Asia’s real estate market has developed rapidly, with Singapore, Hong Kong, Japan and Australia now rivalling North America and Europe in terms of transparency and maturity.
- Structural economic adjustment is boosting real estate demand within the region. Intra-regional trade and investment has grown robustly over the last decade leading to greater economic resiliency.
- Increased business activity within the region gives developed economies the opportunity to benefit from the structural emergence of developing Asia – including strong demographic growth, increasing urbanisation, rise of the middle-income class and growth of the services sector.

### Fig. 1a: Asia’s position in the global economy

<table>
<thead>
<tr>
<th>Global GDP by regions</th>
<th>Asia Pacific 30%</th>
<th>European Union 23%</th>
<th>United States 23%</th>
<th>ROW 24%</th>
</tr>
</thead>
</table>

2013 Global GDP estimated at US$74 trillion

Source: IMF

### Global growth engine

At the macro level, Asia offers dynamic economic conditions, strong growth and favourable long term fundamentals. Over the past decade, Asia’s gross domestic product (GDP) per capita has grown on average by 7.4% per annum, more than double the rate seen in both the US and the European Union. Such outperformance is expected to continue in the medium term, driven by the emerging markets of South East Asia and the maturing of the Chinese economy, as well as by the structural transition from manufacturing to services and from exports to consumption. These trends in turn benefit the region’s developed economies through increased intra-regional business activity.

The rapid expansion has made Asia Pacific the largest economic region in the world, accounting for some 30% of global GDP in 2013. Its resilience to Western economic downturns, as shown in the 2008/9 financial crisis, underscores the robust nature of the region’s economies and the diversification benefits for North American and European investors.

1International Monetary Fund.
Sustainable growth has brought significant wealth and economic maturity to the region. This has erased much of the income gap between developed Asia and the economies of North America and Western Europe. China, India and South East Asia are forming the next wave of economic development, which will again benefit the region’s developed economies over the long term.

Our analysis of Asia’s real estate markets shows that performance within a single country is quite consistent across real estate sectors, suggesting that tactical allocations between countries are a more significant driver of outperformance than rotating between sectors within a country. This is consistent with general evidence that real estate performance over the long term is driven by economic fundamentals and nominal GDP growth\(^2\).

Whilst this does not mean that larger allocations to a country with higher nominal GDP growth will guarantee outperformance in any discrete time period, it does suggest that such investments should lead to relatively strong real estate returns over the long term. The established premium of Asia’s economic performance over Europe and the US is a key consideration, underpinning investors’ incremental allocation to the region.

**Asian real estate comes of age**

The growth and development of the market has led to improvements in:
- Quality of stock;
- Liquidity;
- Transparency; and
- Lease covenants.

Leasing practices – or the “terms of trade” – in developed Asian markets have become similar to those of Europe or the US, thanks in part to growing transparency and standardisation. This evolution has been supported by longer lease duration and enhanced security of the income returns which underpin long term investment performance.

In addition to Australia (often ranked as the most transparent market in the world), other real estate markets in the region – such as Hong Kong, Singapore and Japan – now rival those of Western Europe and North America in terms of transparency and maturity, as defined by the proportion of institutional ownership. These structural developments have led to a significant compression of risk premium over the last decade.

The structural evolution and the scale of the market are attracting a growing pool of investors, in turn helping to fuel further development. Indeed, with the exception of Japan, Asian institutional investors increasingly see real estate as a mainstream asset class alongside equities and fixed income, leading to greater liquidity and market maturity.

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\(^2\) Using data from IPD and the IMF for the period 2000-2012, our correlation analysis of real estate performance and nominal GDP growth across Asian and global developed markets showing an average correlation coefficient of 0.7.
The globalisation of real estate investment has also led to accelerated foreign capital flows into Asia, establishing the region’s position as a strategic allocation in a global portfolio. Several major international institutions – pension funds and multi-manager investors – have established offices in the region to gain better access and knowledge as their allocations to Asia grow.

As a result, Asia Pacific has become a viable and attractive option for investors with a relatively low risk threshold. A core investment approach to the region particularly suits those seeking diversified and long term exposure to the real estate asset class.

**Sustainable occupier demand**

Asia’s structural and economic shifts, as discussed earlier, underpin demand for modern and high-quality commercial real estate across the sectors:

- The secular shift of employment towards the service sector establishes a long term trend of growing demand for offices. This is backed by the rise of Asian brands, who increasingly need office space to support their global expansion, as well as by the growth of industries such as finance, health care and technology in developed Asia. For example, Singapore has rapidly emerged as a key global hub of private banking and consumer financial services.
- The emergence and rapid growth of the middle-income class is driving retail sales and thus the appetite for quality retail shopping space. The Asia Pacific retail market is the world’s largest, with the share of total global retail sales forecast to increase from 25% in 2007 to just over 40% by 2017. In addition to the growing spending power of domestic shoppers, countries across the region are benefitting from the explosion in consumption and intra-regional tourism, particularly from China.
- The growth in consumption and trade volumes is also driving the demand for third party logistics services and distribution networks, underpinning the need for industrial and logistic space. This is further accentuated by the structural undersupply of modern logistics in Japan, Hong Kong, China and South Korea, as well as by the growth in online retail across the region.

Together, these structural and economic shifts create an environment for continued strong occupier demand, reducing the risk of vacancies and boosting the prospects for rental growth over the medium term.

**Diversification and return**

Historic performance of the developed Asian property markets reflects the dynamism of the region. Over the decade to 2012, Asia Pacific real estate delivered an average annual return of 8.2% with an average volatility of 13.1%.

Our analysis of global allocations for a selection of US, UK and Eurozone institutional investors shows that an investment allocation to Asia Pacific results in an improved risk/return trade-off. Increasing international exposure will also clearly boost Eurozone investors’ geographical diversification.

To measure the diversification benefits, we have modelled the risk/return expectations when investing outside of the home market with and without Asian exposure. For Eurozone investors, it can be argued that they are taking too little risk within their real estate portfolios by allocating solely within their home region. Increasing their risk profile to an acceptable range to

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Fig. 4: Maturity and transparency of Asian real estate versus other developed markets

Fig. 5: Annual return and volatility

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Performance data from IPD and PMA; Regional statistics weighted by DTZ’s market capitalisation.
include investment in Asia thus has the potential to incrementally increase returns whilst maintaining the same level of risk-adjusted return to the portfolio.

For US and UK investors, a global portfolio clearly helps to reduce overall risk and, within that, exposure to Asia makes the most significant impact on reducing the volatility of returns. US investors seeking to diversify through exposure to Europe alone are generally subject to lower returns than those who also invest in Asia. For UK investors too, our research shows that adding Asia has the potential to significantly boost risk-adjusted performance.

The trade-off between increased returns and higher risk reflects the increasing efficiency of real estate as an asset class, which allows sophisticated investors a wider opportunity set to allocate their capital in an optimal manner in order to achieve their target risk-adjusted return over the long term. Historical performance clearly indicates that Asia should form part of this global opportunity set.

The dynamism of Asia also allows for intra-regional diversification without straying from core. Opportunities include the higher growth prospects in Singapore and Hong Kong, the strong economies of Australia and Korea, together with the stable income-driven returns of Japan.

A pan-regional mandate would enable investors to focus on the most attractive countries and sectors in dynamic markets to optimise return and risk. As China’s Tier One cities (Shanghai, Beijing, Shenzhen, and Guangzhou), Indian cities, Kuala Lumpur, Jakarta and others reach maturity, the opportunity set for core investors will widen further.

Based on the above analysis, a 20-30% allocation to the Asia Pacific market can be expected to give Eurozone, US and UK investors the following risk/return profile:

<table>
<thead>
<tr>
<th>100% Domestic investment</th>
<th>Portfolio with 20-30% APAC investment</th>
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</thead>
<tbody>
<tr>
<td>Return (pa)</td>
<td>Volatility of return</td>
</tr>
<tr>
<td>Eurozone investor</td>
<td>5.6%</td>
</tr>
<tr>
<td>US investor</td>
<td>8.5%</td>
</tr>
<tr>
<td>UK investor</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

Source: M&G Real Estate

Benefits of investing in unlisted real estate funds vs listed REITs

Investors looking at Asian real estate have a growing universe of potential investment vehicles, including specialist funds and listed REITs. REITs benefit from better liquidity, but investing in Asia directly through an unlisted fund offers a number of other advantages. These include:

- Lower volatility;
- Broader geographic reach across the region, given that currently only Australia, Japan and Singapore offer well-developed REIT markets;
- Returns closely linked to property market performance; REITs, in contrast, behave more like equities;
- Asset-level diversification through fund portfolios of a significant scale which can efficiently diversify structural risk; in comparison, individual REITs can be highly correlated.

Conclusion

As Asia’s real estate market comes of age, it is no longer an investment greenfield for the opportunistic – it has all the characteristics to earn a key place in a diversified global core real estate portfolio. Early investors are benefiting from the structural advancement in the region’s real estate markets, with the strong improvements in both market size and quality.

Our research shows that investment in core Asia Pacific real estate has the potential to provide strong diversification benefits and the potential for long-term, sustainable income-driven returns, backed by economic growth.

These benefits can be maximised by investing in Asian real estate through a specialist fund, which offers local expertise and active asset management, as well as greater control and lower volatility compared to indirect investments through REITs.
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