

# ULI Asia Pacific Capital Markets Forum

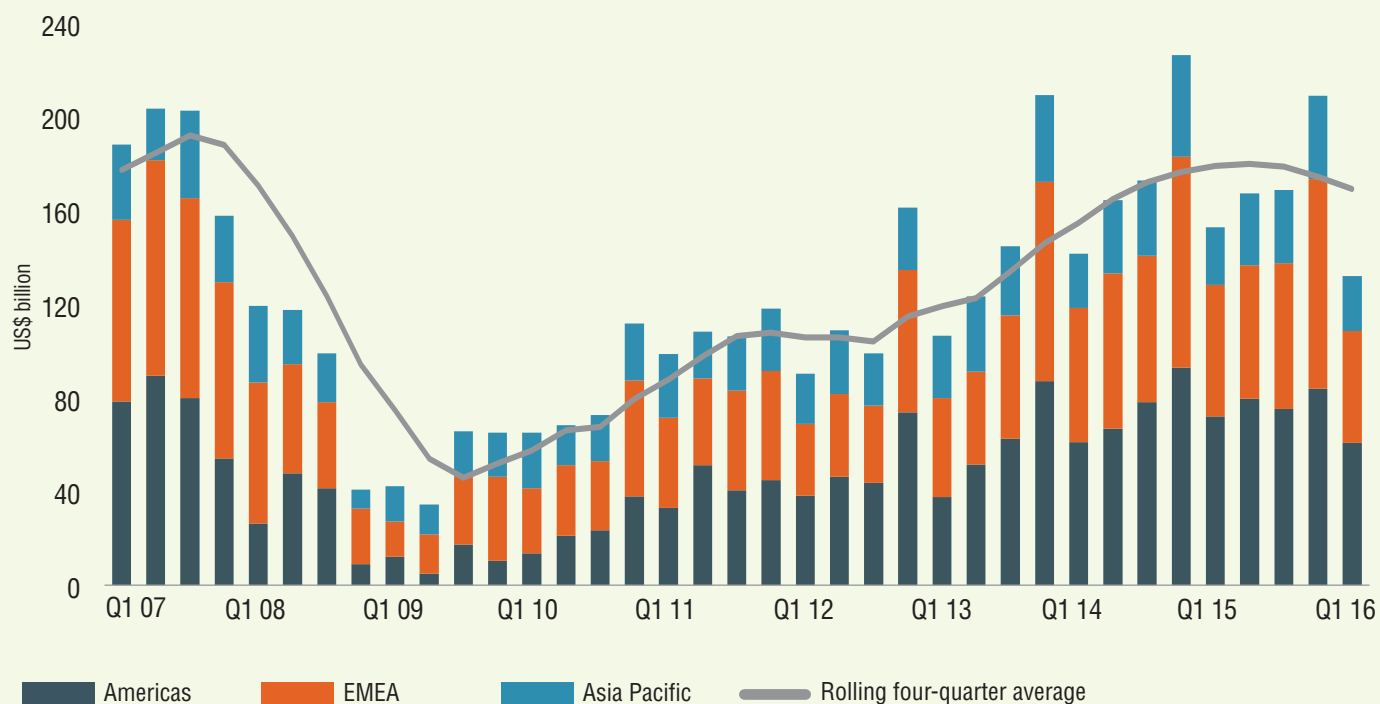
Ongoing turbulence in the global economy has done little to stem the flood of new capital targeting Asian real estate, the product of huge amounts of institutional liquidity on the one hand and chronically low returns for other asset classes on the other. The implications of this buildup of new capital provided the backdrop for this year's ULI Asia Pacific Capital Markets Forum, held in Shanghai in June, where investors discussed issues ranging from the impact of e-commerce on the industry and the explosive growth of outbound cross-border investments to strategies adopted by investors to cope with currently high levels of systemic risk.

**Cash stockpiles** may never have been bigger, but recent transaction volumes suggest that investors have not been anxious to open their wallets. According to JLL, the value of global commercial real estate deals was down 14 per cent in the first quarter of 2016 from a year earlier, reaching levels last seen in 2013. Investors have been put off by uncertainties created by an array of global economic problems.

The falloff of investment in Asia, however, has been less severe. After peaking in mid-2015, regional transactions dropped a relatively modest 5 per cent year-on-year to US\$24 billion in the first quarter. What's more, most of this decline resulted from a drop of investment in Japan, where the introduction of negative interest rates by the central bank has led vendors to delay sales



## Direct Commercial Real Estate Volumes by Region, Q1 2007–Q1 2016



Source: JLL.

as they seek to refinance assets. Transactions in China, Australia, and most other Asian markets, by contrast, remained strong.

Another noteworthy trend from the first quarter was ongoing strength in Asia's intraregional investment flows, which more than tripled year-on-year to US\$4 billion even as incoming capital from global investors fell to US\$1.2 billion—roughly one-quarter its year-ago level.

This emerging dominance of Asian capital in financing regional cross-border deals is significant because local buyers are generally more willing to meet high prices demanded by sellers. Nowhere is this more evident than in China, where cap rates of just 4.5 to 5 per cent make it, as one forum participant said, 'probably the most challenging of all markets in Asia'.

With yields in major Chinese cities comparable to those in gateway markets in the West, some international investors see little

appeal. 'What we're seeing right now from a relative value standpoint is that investors are concerned they're not getting paid for the risk in China,' one said. 'They'd rather be able to put their money into a market where they can sleep at night, like Japan or Australia.'

Investors cited various China-related risks, including higher taxes, inefficient capital investment structures, currency depreciation, shortage of good stock, doubts regarding renewal of ground leases, and potential problems with repatriation of cash flow.

That said, many investors with in-country experience in China retain a positive outlook, preferring instead to focus on a still-thriving economy. At about 6.5 per cent, annual growth in gross domestic product in China may have slowed, but it remains by far the best of any major economy in the world, leading inevitably to significant asset price appreciation.

'The dichotomy is that anyone that's new—and there's a huge amount of new capital



going into Asian real estate—is just taking at face value what they read in the [foreign press] and want you to carve out China,' said one fund manager. 'So it's literally split down the middle as to those who are coming to Asia for the first time and those who have the experience here.'



# The Impact of E-Commerce

No consumers in the world have been quicker to embrace e-commerce platforms than those in Asia, which today sees more internet sales than anywhere in the world. This explosion in online purchasing has had a dramatic impact on regional logistics and retail sectors.



In the warehousing space, chronic shortages of modern facilities persist across Asia, especially in China, which one investor described as 'way undersupplied'. This has made the region a magnet for specialist logistics developers from the West, where markets are now saturated. Demand is currently growing faster than new supply,

at least partly because online retailers' requirements have created a new dynamic for warehouse construction. In particular:

- **Clients need more room.** E-fulfillment requires three times the storage space needed by brick-and-mortar retail because of high levels of inventory return, broader product variety, and the need for individual product packaging and shipping. 'A shed is the new shop,' as one investor put it.

- **E-fulfillment today is focused on speed.** With online retailers committing to ever-shorter delivery periods (sometimes a matter of hours), logistics facilities must be closer to customers and adopt technology geared for fast turnaround. As a result, said one investor, 'the advantage you now have in China versus the USA is the incredible infrastructure: new buildings are state-of-the-art. In that respect, it's creating a very functional logistics base you don't necessarily have elsewhere.'

At the same time, obtaining land for logistics development is problematic. City governments in China prefer to build office and retail properties because they generate higher tax revenues than do warehousing projects. As a result, some

cities have reduced ground-lease terms for industrial space to a maximum of 20 years, making many projects uneconomic.

The policy is exacerbating the ongoing shortage of logistics facilities, especially around city centres. One result is increasing demand for multistorey capabilities. Though this reduces land costs, such sites are not as appealing as they sound. 'You lose out in efficiency,' said one developer. 'A single floor is always best—one side in, the other out. Once you go to a second floor, you have to build a lift or a ramp. It's expensive.'

With demand for logistics facilities booming, more money is now chasing assets in short supply. Said one investor, 'Once a property is stabilised, lots of capital is looking to buy, not only from logistics players, but also from the core-plus market.'

At the same time, difficulties obtaining land for new development continue. As a result, rents have risen rapidly at the top end of the market. Cap rates for high-quality Chinese logistics projects have declined from 17 per cent a few years ago to 6 to 7 per cent today, one participant said, and are probably set to sink below 5 percent.



# Retail

The impact of e-commerce on the retail sector has been equally profound but much less beneficial, with sales at brick-and-mortar retailers down about 20 per cent from historical norms as shoppers migrate to online platforms.

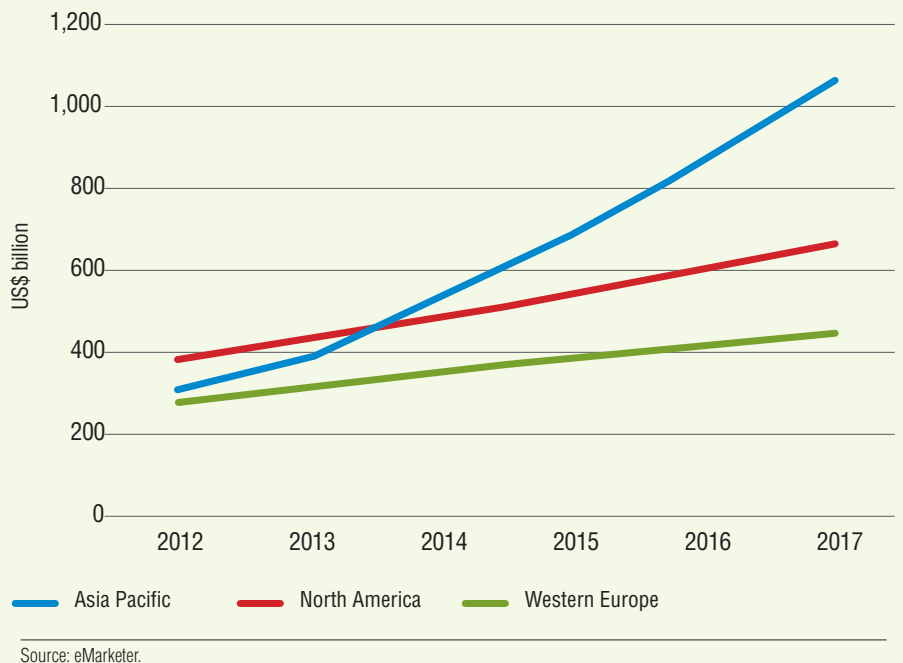
Shopping centres are responding by boosting their food and beverage (F&B) component to as high as 40 per cent of the total. That only gets them so far, however, not least because the resultant drop in rental income affects mall valuations. The result is that 'large-scale shopping centres are now in terminal rent decline', one investor said. 'There's only so much F&B that can replace it. Operators can expect a 15 per cent to 20 per cent reduction in rent growth over the next few years, with cap rates moving out.'



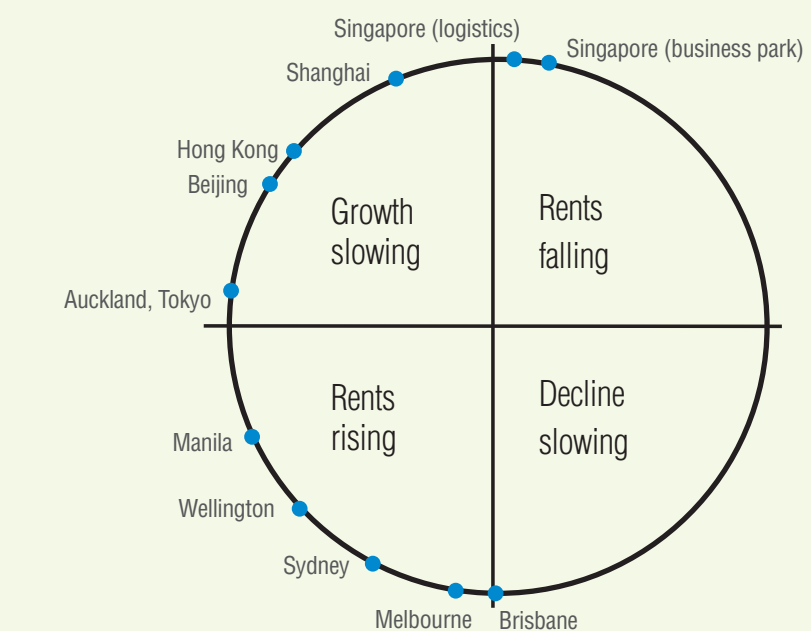
In addition, the big department stores that usually function as anchor tenants are being 'absolutely hammered' by online competition, as one participant said, often undermining the financial viability of the entire mall. Said one developer, 'That's a real problem because shopping centres are just too big to rejuvenate without massive capital investment, whether that means promotional events or physical change.'

Is there a solution? One participant suggested that landlords 'cooperate rather than trying to kill each other' in an effort

B2C E-Commerce Sales Worldwide, by Region



Industrial Rents—Location-Specific Depending on Quality and Demand



to enhance the overall shopping experience. Another suggestion was to overhaul leasing models to reduce the proportion of rent based on store turnover, which has fallen as shoppers opt to browse in-store and buy online. Addressing this problem has become the holy grail of fixed retail. As

one developer put it, 'If anyone can crack the nut of getting a percentage of online sales from a physical store, I'll pay a lot of money for that.' One suggestion, made only half jokingly, was for landlords to charge admission fees for entry to malls.

# Outbound Capital Flows

Also discussed at the forum was the huge amount of Asian capital now being directed into cross-border deals. Although this flow began only around the beginning of 2014, outbound capital has quickly grown to massive proportions.

In the first quarter of 2016, Asian capital invested in commercial cross-border real estate totaled US\$8.6 billion, according to JLL, of which about \$4 billion was directed to markets in Asia, with the rest split in roughly equal measures between Europe and North America.

While a tightening of government regulations in China has meant that overall outflows from Asia have seen a pullback during the first quarter of this year, there seems to be little doubt that future cross-border deal flow will dwarf what has been seen so far, as capital reserves pile up across the

region and official policies restricting capital exports continue to be loosened.

In particular, forum participants see current Chinese capital export controls as a stop-gap imposed to allow authorities to form a policy response to concerns that outflows may erode China's currency and foreign exchange reserves. The likely result, according to one locally based participant, will be that 'they'll streamline outbound flows. Rather than open it up to everyone, they'll take a few experienced channels—not private players—and use those to deploy capital. Because once China opens up for everyone, there are going to be issues.'

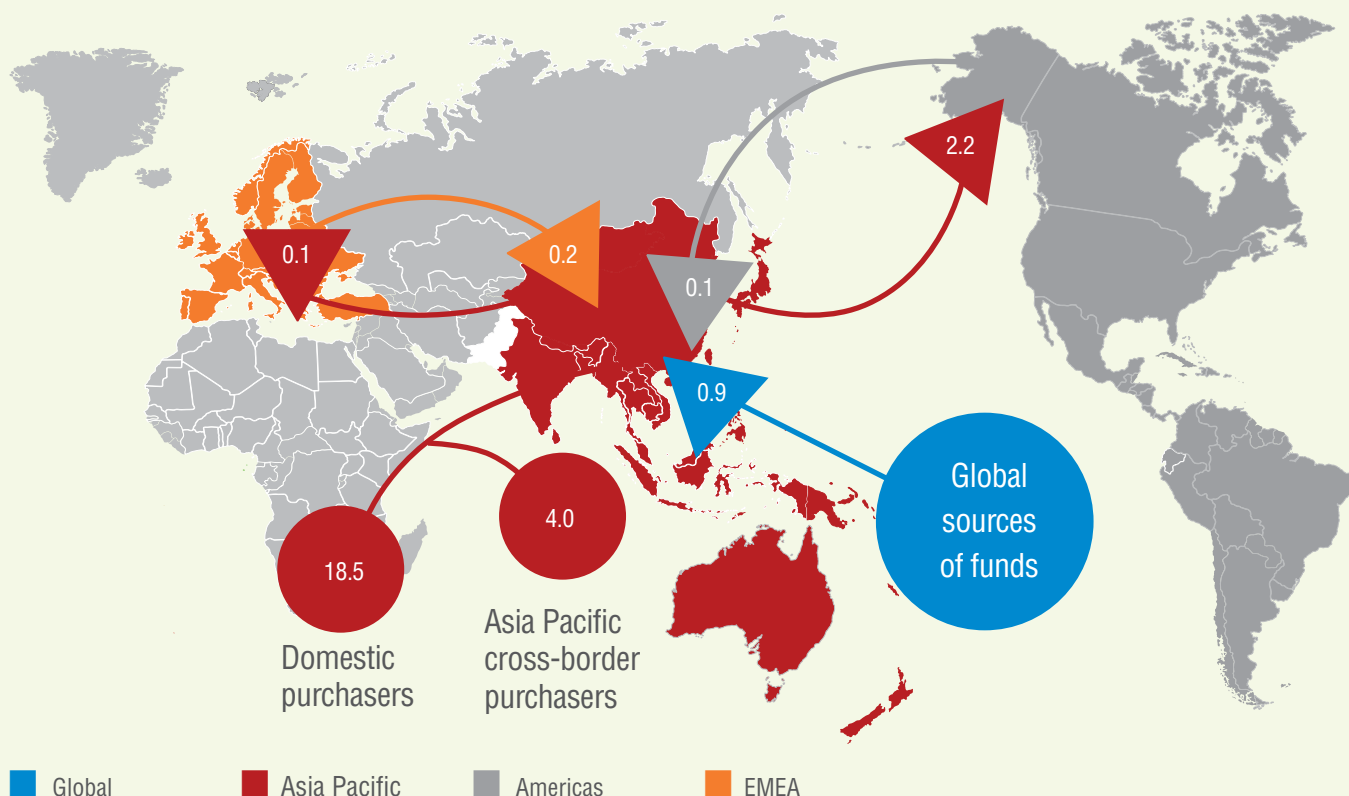
Meanwhile, the forces that have served as catalysts for Chinese cross-border flows continue to build. Although the majority of capital leaving the country has until now

come from developers looking to diversify their business in response to declining margins from domestic property investments, a major source of future cross-border capital is likely to be institutional players, in particular Chinese insurance companies.

According to JLL, domestic insurers may inject a further US\$240 billion into international real estate assets in coming years if they make the same 15 per cent allocations to the sector that are targeted by their international counterparts. This is a huge amount given that global commercial property transactions currently stand at about US\$730 billion a year.

In terms of investment targets, Asian buyers have maintained a conservative strategy. 'They are still leaning toward trophy assets in gateway cities, though that's changing a bit,' said one fund manager. 'They also want

Purchaser Flows into and out of Asia Pacific, Q1 2016 (US\$ billions)



Source: JLL.

to do things in direct or joint venture form as opposed to joining funds.'

One recent problem for Chinese investors is the need to obtain official approval as Beijing works out how to control the flow of outgoing cash. Red tape is currently delaying foreign deals by six to 12 months, with no guarantee of a positive outcome. This is proving to be a stumbling block in markets such as New York City, where sellers often expect buyers to close deals quickly.

While China remains Asia's biggest cross-border investor, many others have joined the capital exodus. South Korea, for one, has a handful of sovereign fund-type investors and another 20 to 25 institutional players. One fund manager described it as the 'biggest, most consistent pool of Asian institutional capital targeting fund-type or comingled investment structures'. Said one panellist, 'They take comfort in numbers and they like to invest together in clubs, but the focus is on income and visibility.

That means debt-oriented, income-oriented investments, and also visible portfolios, as opposed to blind funds and blind pools.'

The joker in the pack, meanwhile, remains Japan, whose US\$1.2 trillion Government Pension Investment Fund (GPIF) ranks as the world's biggest. So far, Japanese institutions have very small allocations to domestic real estate assets—about 2 per cent. Historically, they have been conspicuous by their absence from Asia's rush of outgoing capital. That seems set to change, though, as Japanese funds seek the higher returns needed for upcoming payouts to the country's rapidly aging population.

The GPIF and other major Japanese institutional funds have recently taken steps to hire staff with expertise in alternative investments (including real estate) in preparation for investing internationally. One Tokyo-based fund manager identified Japan as the region's 'most promising pool of capital', adding he 'wouldn't be surprised to see them

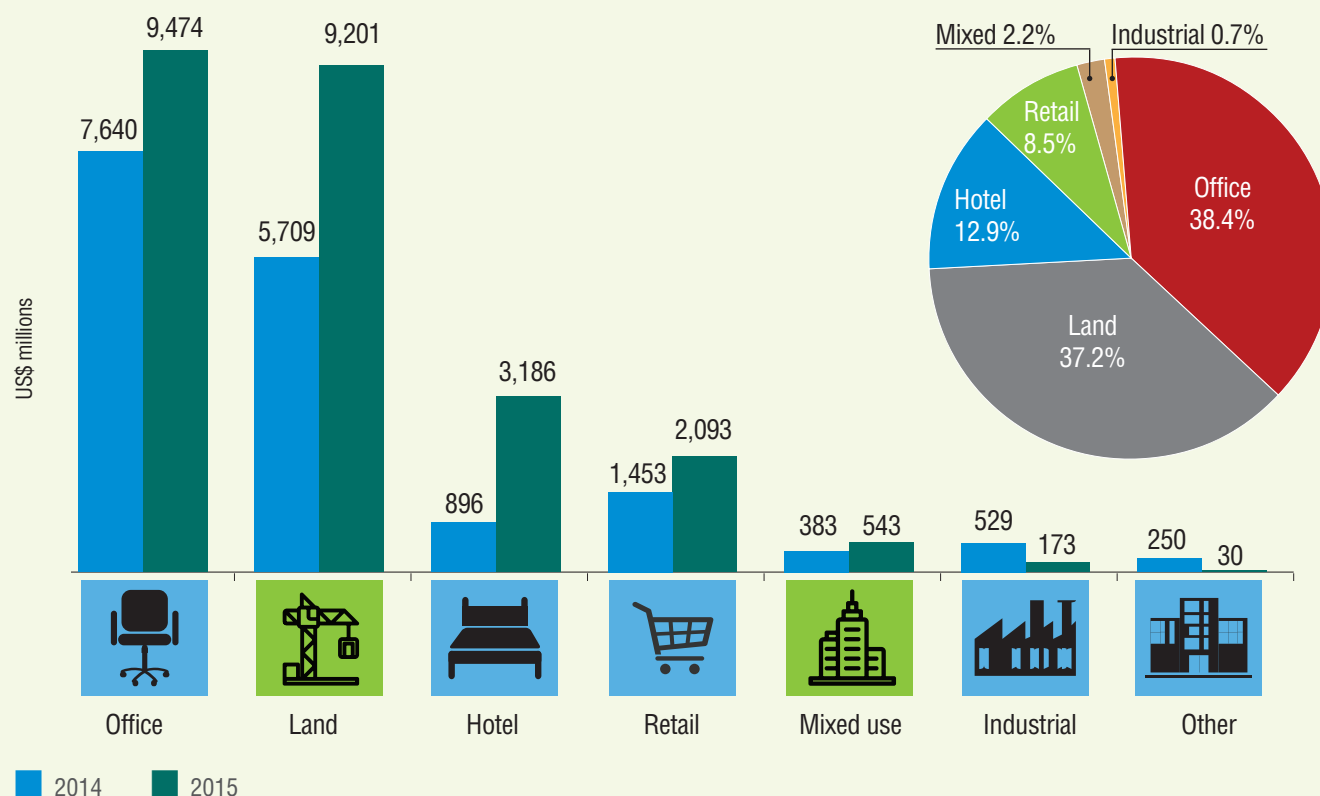
start buying by the end of this year'. Also, on the debt side, Japanese lenders besides the big three domestic players are for the first time beginning to lend outside Japan, again largely as a means of boosting vanishing margins in their domestic market.

The collective impact of this new surge of outgoing institutional capital from Asia may drive a new round of global yield compression.

'This is something that's never been seen before, and we are expecting outbound flows to create a new low in terms of global return,' one panellist said. 'Over the last five to ten years, Asian capital has become used to lower returns [in Asia] than we've seen in gateway cities [in the West]. If some of the [Asian] governments open up more, we are going to see another round of decreases in cap rates. They could go even below 2 per cent.'

So, where do markets go from here? One thing on which panellists agreed was that the contradictory themes are set to persist. Markets will become more crowded,

## Direct Real Estate Investment by Sector, 2014 and 2015



Source: JLL.

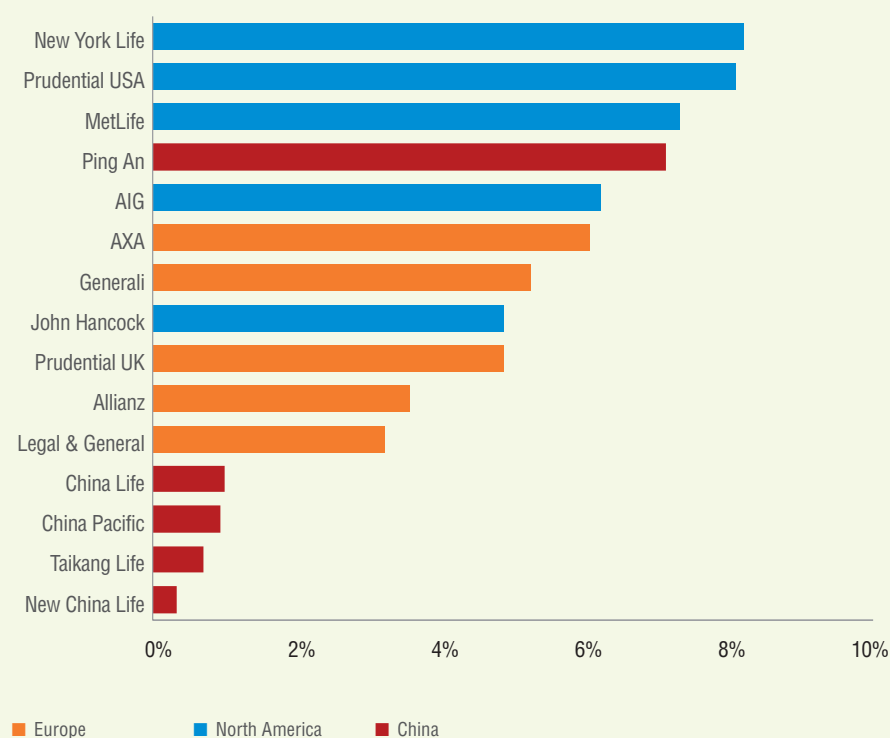


therefore, as outflows of institutional capital from major Asia Pacific markets continue to accumulate.

At the same time, investors have turned gun-shy amid a backdrop of heightened risk. 'We've seen a ton of volatility in Asia over the last two or three decades, and we're all used to that, but it does feel like risk in general seems higher given what we've seen in the market over the last four or five years,' one fund manager said.

Risks range from the potential impact of a Chinese debt crisis to the knock-on consequences of the U.K. exit from the European Union—identified by a manager at one large investment group as 'the biggest concern of every single investor in my funds'. With Brexit now a reality, more buyers may opt to remain

## Real Estate Allocation by Insurance Companies, by Company and Region



Sources: CEIC; company accounts; www.reilbanks.com, 2014.



on the sidelines as they pause to digest the implications.

Investors are responding to this high-liquidity/high-risk dynamic in various ways. One obvious impact is that investors now 'have to take more risk for lower return, and you've just got to get your head around that', one participant said. In addition, as return expectations shrink, investors are now more focused on cash flow. Mezzanine lending was mentioned as a particular opportunity, given that banks are now tightening their lending criteria.

Another viewpoint was that ongoing urban migration in Asia would continue to favor investments in good locations in prime cities. 'The city is winning, and the centre of the city is definitely winning,' as one forum participant put it.

One fund manager suggested a mix of growth and defensive investments: 'Looking at fundamentals, people are still spending money, so you might look at urban retail centres for defensive plays, and you might look at logistics and at

hospitality as growth industries. Then perhaps you overlay that with a call on particular countries or cities. Is there real wealth being created? So you adopt your strategy according to what's happening in those sectors, and you go for some high growth—might be logistics—versus solid income from retail centres.'

Finally, making better provisions for risk—in terms of both time and money—and improving strategic positioning of portfolios were identified as further themes.

'Ultimately, we are spending more time on research of fundamentals,' said one fund manager, 'because you don't want to be in a market where cap rates have come down, supply is kind of high, debt levels are increasing, and an exogenous shock triggers a significant downturn. So we're looking either for shorter-term plays or for something that can ride out the cycle on a longer-term basis. It's the three- to five-year deals we're a little concerned about.'

# ULI Asia Pacific Capital Markets Forum

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