

# ULI Asia Pacific Capital Markets Forum

**As ever-growing volumes of capital continue to chase a limited pool of real estate assets, investors across the globe are moving up the risk curve in search of yield. The fierce competition to place capital is reflected in the main themes discussed in this year's Capital Markets Forum in Hong Kong, with new money from Asia driving prices higher in gateway cities in Europe and the United States, and pushing investors to test new strategies in secondary markets and asset classes.**

**The overarching trends** of more money and more competition are seen clearly in the statistics. According to recent figures published by Jones Lang LaSalle, global commercial real estate transaction volumes returned to pre-global financial crisis highs for the first time in the fourth quarter of 2013, and show no sign of slowing—activity in 2014 is expected to grow some 10 to 15 percent from last year's total of US\$650 billion.

Until now, most of this capital had been targeted at a limited number of markets. Around 50 percent of commercial real estate investment last year was sunk into just 30 major cities across the world, according to Jones Lang LaSalle, and in particular into core properties in gateways such as London, Paris, and New York City. Today, in the face of increasing competition for assets, supply shortages, and ongoing cap-rate compres-

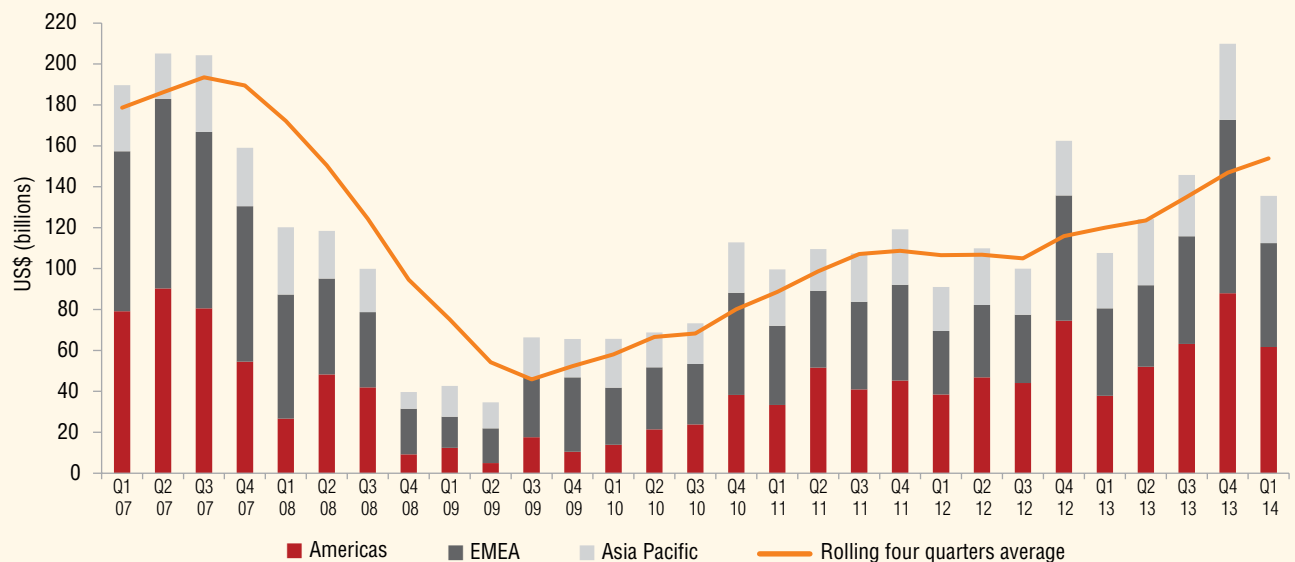


sion, a new mix of target markets, sectors, and asset types is evolving.

What does this mean in practice? First and foremost, it means investors are migrating up the risk curve, looking to reposition and

Thirty leading executives in the world of real estate capital markets and investments gathered at the closed-door forum in Hong Kong for an open conversation about the future of the capital markets and the challenges the industry will face.

## Direct Commercial Real Estate Volumes by Region, Q1 2007–Q1 2014



Source: JLL.

later resell assets into the growing weight of institutional capital now targeting core property. The problem is that this strategy is not exactly new. Said one forum participant: “We are now exiting successfully out of assets where we took a bet on there being core investors available for when they were completed. It’s proven a good bet, but it’s a challenge to repeat it today because core money is now taking more risk, pushing us into secondary product types or locations to stay ahead of them.”

The current environment, however, leaves many investors with little choice but to venture outside their comfort zones, so the strategy is being revisited by investors in various regions, and particularly in Europe, where prices appear to be bottoming even as banks and government agencies continue to kick portfolios of nonperforming assets into the market. Milan, Brussels, and Madrid were all identified as the type of “not yet core” secondary-market destinations that might offer value-add plays leading to potential opportunistic returns on resale to core buyers.

That said, with so many new investors lining up to buy, competition for these types of deals is also becoming intense. In Spain, as

one fund manager observed, “It’s both too early and too late” to invest, because “the fundamentals are nowhere near where they need to be to justify some of the transactions there, while the pricing is so far ahead of the fundamentals that you’re too late to go in.”

According to another fund manager, the fact that Spanish rental volumes and prices are now down 60 percent from their peaks provides an obvious upside. Still, too many investors “seem to think Spain is the next coming—in reality, the competition is stiff, and the yields don’t feel like opportunistic yields; they feel like normal yields. There’s just more upside because prices have come down so far.”

Today, that perception applies to a greater or lesser extent across the whole of Europe, with the result that typical opportunistic yields of 20 percent-plus are almost impossible to achieve without factoring an upward move in pricing into the underwriting. As one participant observed, “It’s very tough to do better than mid-teens [returns] on the numbers you would underwrite. Maybe, if you get an economy that’s recovering, or maybe if your exit assumptions are too conservative. But just about everywhere you look, returns are core or core-plus—you hit the high single

digits, and everything further up the risk spectrum is somewhere between, say, 10 and 15 [percent].”

The market in the United States offers a similar dynamic. Ongoing yield compression has seen investment flows diverted increasingly to secondary destinations as incoming capital—much of it from Asia—crowds into the gateway cities. One investor registered surprise at how U.S. property markets have managed to weather an economic rebound that, now two years in the making, has become rather long in the tooth—certainly longer than in Europe or Japan, where macro indicators have only recently begun to gain traction.

Can that strength continue? Opinions on this varied, but despite pricing levels described as “a little breathtaking by historical standards” the saving grace for U.S. markets is seen in an ongoing supply-side shortfall accompanied by the functional obsolescence of much existing stock. The result, according to one fund manager, is that “with the exception of multifamily residential—which I’d say is in the middle or even beyond the middle of the game—but for all the other property types, and particularly industrial, you’re not beyond the third innings.”

# Asian Markets Lag

Asia, meanwhile, remains something of an enigma. Despite ever-growing supplies of new capital, transactions across the region declined almost 15 percent year-on-year in the first quarter of 2014, according to Jones Lang LaSalle figures, mainly due to a sharp slowdown of activity in China. In part, this is a result of the mainland's slowing macro environment, but it also reflects a perception that returns in China have compressed to the point where investors question whether they now justify market risk, especially given apparently higher returns now available in the West. As one participant observed: "We used to invest quite a lot in China, but in the last few years we've put out quite a lot less because we're not seeing the same kind of returns."

Despite this, most participants agreed that the fundamental outlook for China—as for Asia generally—remains strong, with short-term volatility offset over the longer term by the wealth effect of a growing middle class and rising rates of urbanization. One upshot of this is that, although the easy money in

**Although Asian markets now attract more capital, transactions have declined in the last year.**



China may now have been made, the future landscape is likely to favor a different type of investor who is not defined by conventional, short-term investment windows. As one fund manager said: "If you're not a market-timer, and you don't have to harvest in four to seven years, you have a very different perspective."

In addition, current indicators suggest that market conditions are creating severe stress within China's fragmented development sector. With tens of thousands of small and midsized players now feeling the heat, a radical consolidation of the sector may now be in the offing, finally providing a chance for foreign funds to participate in distress situations. As one investor said: "For sure we're going to see consolidation of the smaller guys who need sales to continue to grow." According to another: "There may be between 60,000 and 80,000 domestic developers and probably [fewer] than 100 big players, so it's going to be like the RTC [Resolution Trust Corporation] days—those with cash are going to have a great opportunity. They won't necessarily be distressed properties; they'll be cash-stressed developers who bit off more than they could chew."

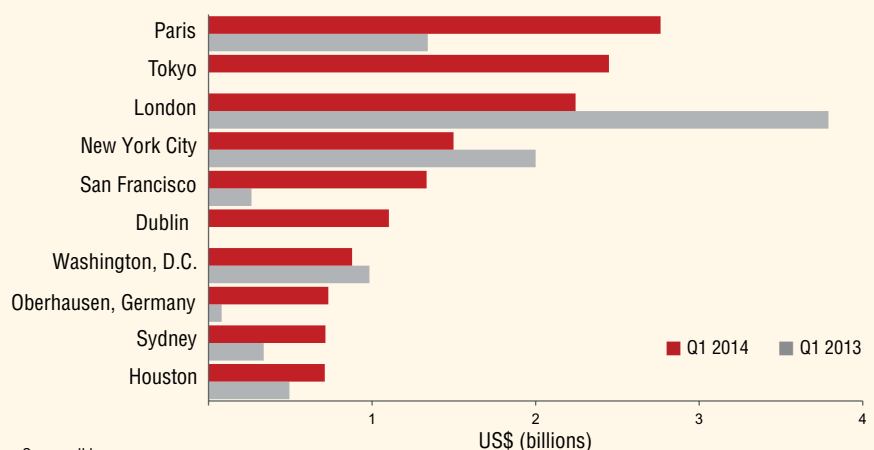
Finally, there was also consensus that the best time to act in China may be now, while the market is on the downside of the cycle.

This is because "if you invest when the market is going up, your nominal price point may be exactly the same, but you're getting much better terms if you invest earlier." And, as another investor said, "The biggest opportunity in China now is that you can do business on good terms with the highest-quality partner. It's not because they need money; it's because they want more money to take advantage of the distress and the 30,000 guys who never should have been in business in the first place."

The exception to the generally anemic investment mood in Asia has been Japan. Investment volumes in 2013 were double those of the previous year, while commercial real estate transactions in the first quarter of 2014 ranked Tokyo the top city globally—the first time it has occupied that spot in some ten years. Just as remarkable, cross-border investment activity in Tokyo mushroomed to 25 percent of the total during that period, up from a virtual standstill in recent years.

This renaissance in the Japanese real estate market is a byproduct of the radical stimulus policies introduced by Prime Minister Shinzō Abe, which have now arrested more than 20 years of property-price deflation. "Abenomics" has driven a wave of cap-rate

Ten Largest Recipients of Cross-Border Investment, Q1 2014



Source: JLL.

compression in Japan over the last 18 months, with unlevered yields coming in from about 7.5 percent to a current 5.5 percent for Tokyo grade-B office, according to one forum participant.

The question now, however, is how much more compression the market can take—especially given that most investors are now underwriting a measure of rental growth into their deals in order to make the numbers add up. According to one participant: “Japan has been written off many times, but it’s still there. They have 100 million-plus people with lots of money, and they tend to spend it, so I’m optimistic until the 2020 Olympics because the wall of money that will be entering the economy will overcome all these very negative long-term trends in an aging country. So if you’re an investor for a five-year period, I don’t think there are worries.”

One factor that continues to help investors in Japan is easy access to very cheap bank loans. One investor described financing terms as “just unbelievable. That can be both good and bad, but the latest quote we got was 70 percent LTV [loan-to-value], class-B office building, 35 bps [basis points] all-in.”

Still, despite the recent surge in cross-border transactions, Tokyo remains a market dominated by local real estate investment trusts (REITs) and developers, leaving meager pickings for foreign funds. And with opinions divided about the long-term prospects for the local economy, market risk is looming. As one participant observed, “The megatrend is not good, so you have to find these niches of investments within the megatrend. It’s a tactical play, rather than a strategic play, over the long run, meaning we have to pick—if not the submarket, the specific asset class.”

In practice, that might include mid-sized office buildings, where the recovery has been slow. It might also include small multi-family residential assets in Tokyo, which may benefit from demographic shifts that see the number of households increase as fewer people marry and have children.

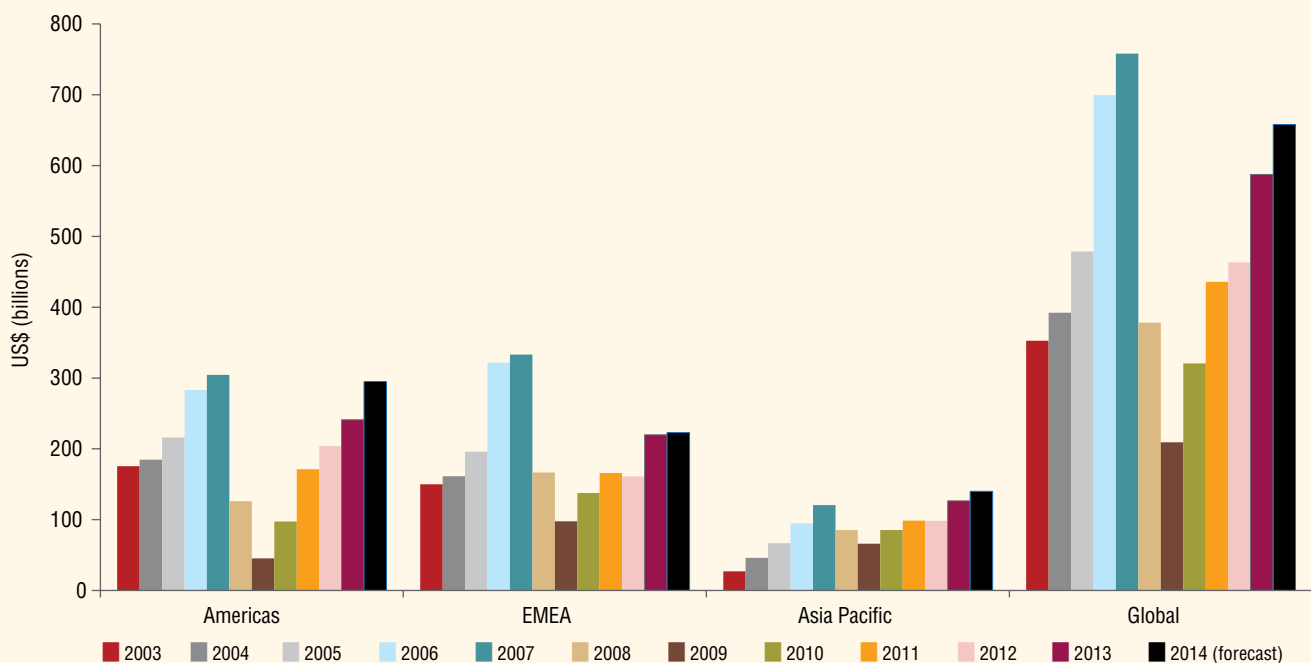
In addition, volatility is an issue. In the words of another investor, “The thing I find a little bit dangerous about Japan is that cap rates are very low, which means the multiple is very high. So you only need a small movement in NOI [net operating income] for your values

to fluctuate a lot, and I think people probably underestimate how volatile NOI is in Japan.”

The final piece of the Asia jigsaw puzzle is Australia. One investor spoke of a “disconnect” between the residential and office sectors there. On one hand, residential demand is now “racing ahead,” supported by chronic undersupply and by capital pouring in from Malaysian, Singaporean, and Chinese developers. On the other, the office sector remains soft, featuring high vacancy rates and tenant incentives.

Domestic ambivalence toward the prospects for the local market has been a theme in Australia for several years, leading one European forum participant to describe Australia as a “paradise” compared with conditions in his home country and to jokingly label it “the most unhappy successful country.” From an investment point of view, however, participants agreed that commercial real estate in Australia would continue to be supported by a relatively modest development pipeline and by the huge weight of capital directed at it—both from cashed-up local pension funds and from foreign buyers who have long been drawn by its transparent, high-yielding nature.

Direct Commercial Real Estate Volumes by Region, 2003–2014



Source: JLL.

# Outgoing Capital

Another theme addressed at the forum was the rapid growth in capital now being directed to real estate assets in the West by Asian investors. What is remarkable about this development is that not only have the last 18 months witnessed a “marked acceleration” of capital moving out of Asia, but that the current surge will be just “the tip of the iceberg” compared with what is likely to follow. As one investor commented, “I think China is where the greatest growth in capital is going to be for real estate globally, with Australia second or third.” As a result, “Asian capital is reshaping the real estate industry—it’s changing the pricing levels of places like London and Paris in a way that as a rule the domestic institutions can’t keep up with.”

Participants identified several reasons for the trend, apart from obvious ones such as the sheer weight of new wealth piling up in regional markets and the perception that assets in the West currently offer better risk-adjusted returns. In addition, participants said, the recent wave of Asian capital migration reflects a newfound willingness among regional investors to move up the risk curve to explore higher-yielding plays, especially once initial deals into trophy assets have been completed. Another catalyst is the constant stream of new players emerging from across the region, in particular more and more Chinese developers, new capital from Chinese and Taiwanese insurance companies, and various capital aggregators in the shape of Chinese and Korean asset

management companies. Their ranks will swell even further should the long-mooted diversification into foreign real estate assets by Japan’s enormous pension funds come to fruition. Finally, the fact that existing outbound investment programs remain immature means flows from these players will only accelerate as more capital enters domestic pools, and as Asian investors seek to meet generally ambitious real estate asset allocation targets (i.e., about 12 percent).

One result of this rush for the exit is that Asian asset managers who until recently were focused on direct deals are now looking also to collaborate with Western funds, either taking stakes in existing platforms or buying them outright. According to one

Institutional capital from Asia was cited as a catalyst for the rapid growth in fund flows to Western markets.



COLIN GALLOWAY

fund manager, “The tone of the discussion, which changed sometime in the last quarter of 2013, is that there’s a greater willingness to give more discretion, either in separate account mandates or in vehicles, clubs, or otherwise.” Another result is that Asian investors who in the past were willing to invest only in gateway cities (i.e., in Europe, London) are now diversifying into other major European destinations—in particular Germany and Paris, but also markets such as Spain, Italy, and even central Europe. The same phenomenon is in play in the United States.

Several investors also noted that some Asian funds—particularly those from South Korea and Japan—are now increasingly open to investing in high-yield real estate debt. This trend began in the United States, but is now emerging in Europe. As one participant said, “They can’t get the money out the door fast enough if they get the opportunity.” Another commented: “That’s exactly the sweet spot we’re seeing from Japan and Korea and the U.S.: going up the risk curve by moving tranches to a low-risk subordinate position rather than leveraging up the debt, and from that

[mezzanine] position getting a high-single-digit/low-double-digit yield.”

Among other things, this newer strategy is seen by Asian institutional investors as a way to limit their overall exposure as they move steadily up the risk curve in their other investments. The trend is seen as having staying power given that many (already undercapitalized) banks in the United States and especially Europe are now hampered by Basel III regulations from providing anything more than 60 percent loan-to-value deals.



The Tokyo market remains dominated by local REITs and developers, despite recent cross-border transactions.

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