



ULI Asia Pacific Capital Markets Forum

The 2017 ULI Asia Pacific Capital Markets Forum, sponsored by JLL and held in Singapore as part of the ULI Asia Pacific Summit in June, again drew 40 leading executives from the world of real estate capital markets and investing for a closed-door session where they brainstormed a range of topical issues facing the industry.

Main Themes

- Long-term prospects across the Asia Pacific region remain positive; however, the short-term challenge is finding enough attractive opportunities.
- European capital is now coming back to Asia Pacific real estate in a big way, with growing collaboration between Asian and European institutional investors.
- Growth versus yield: growth is the catalyst that investors must rely on in order to reach targets for returns in the current environment; however, investors must also take into account the prospect of rising interest rates.
- Technological disruption is about to arrive in the real estate sector, creating as many opportunities as it does challenges. Artificial intelligence, robotics, three-dimensional printing, and driverless cars all will affect the way that investors conduct their future business.

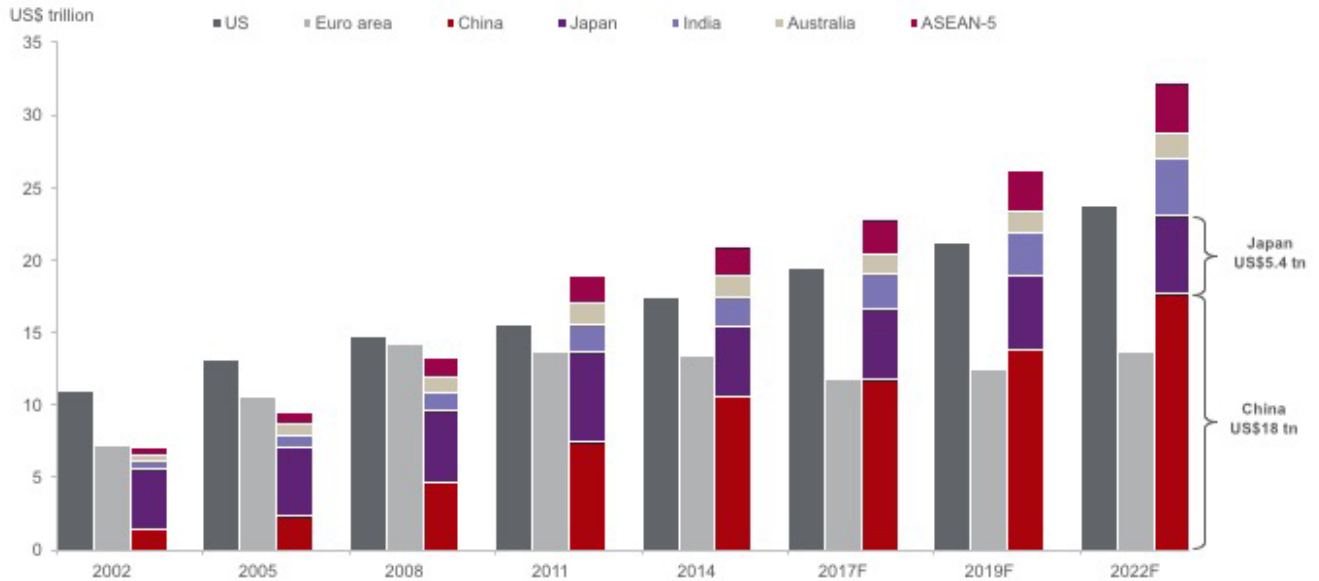
While Asian property investors continue to struggle with longstanding issues of too much capital and too little supply, the consensus among forum participants was that long-term prospects across the region remain generally—and perhaps surprisingly—positive.

According to an analysis of industry fundamentals presented at the opening of the forum, rents in most markets remain on an uptrend, fuelled by higher salaries and ongoing demographic change.

In addition, recently strong economic data have helped boost demand for space. China, for example, recorded year-on-year growth in gross domestic product (GDP) of 6.9 per cent in the first quarter of 2017; Japan, 1.4 per cent (its best return in years); and Australia, 1.7 per cent—

Asia Pacific now exceeds the U.S. as the global market

Nominal GDP, Asia Pacific vs. U.S. and Euro area



Source: International Monetary Fund, World Economic Outlook, April 2017.

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a figure expected to rise to almost 3 per cent by 2018, according to the Organisation for Economic Co-operation and Development (OECD). With emerging markets such as India, Vietnam, and the Philippines seeing GDP grow at rates higher than 6 per cent, the structural story that has underpinned Asian property markets for the past couple of decades seems set to endure for at least a decade, if not more.



The Shanghai Tower is a super-tall skyscraper in the Pudong district of Shanghai.

This growth dynamic has become an obvious draw for fund managers in the West faced with shrinking returns on local assets, limited prospects for economic recovery, and an imperative to diversify in order to mitigate risk. The appeal is especially strong for funds from Europe, which have been conspicuous by their absence among global investors in Asia following massive losses incurred during the global financial crisis.

Several summit participants noted how this insularity is changing, with European pension funds and insurance companies—especially those involving big-ticket investments in core and core-plus assets—actively looking to place capital in Asian markets.

As one fund manager noted, “European capital has been slow to invest in Asia, but is now looking again and in a bigger way. I think many feel they missed out on a few of the past cycles, so this time they want to be in for the longer term.” In practice, funds for Europe tend to be longer-term plays focussed on overarching megatrends—issues such as the regional logistics sector, China’s service sector, and China’s “One Belt, One Road”

initiative to link its interior provinces with Europe, he said.

Putting capital to work in the Asian real estate markets, however, remains problematic given the sheer volume of capital competing to place funds. Various strategies have evolved in an attempt to address this competition. These include investing in the debt space (especially in mezzanine debt and in the Australian market); assuming development risk as a way to create new core assets; and investing directly or by way of clubs, thereby bypassing a glut of capital currently sitting on the books of many funds that managers have been unable to place.

Another nascent trend is for European and Asian funds to team up in an effort to leverage expertise in their respective markets. According to one forum participant, “The new idea is to set up an exchange program whereby a Korean capital insurer, for example, will come and tell us, ‘Find us three assets in Europe. We’ll do a joint venture, and in return when we find something in Asia, we’ll bring you in, and create a joint venture here as well.’”

Outgoing Flows

The other side of the capital flows equation relates to flows of local money migrating out of Asian markets. Outgoing flows have seen massive growth over the past several years as a huge glut of capital held by local institutions seeks better returns and (in some cases) lower-risk sanctuaries offshore. China has been the poster child for this trend, although South Korea, Malaysia, Singapore, and Taiwan also are major contributors to these outflows.

This year, the volume of outgoing capital originating in China, though still large, has ebbed following the introduction of new regulations intended, in part, to impose a measure of financial discipline on domestic investors chasing overpriced trophy assets overseas, and, in part, to stem a torrent of outgoing funds so strong that it threatens to destabilize the yuan and disrupt China's monetary policy.

Though an unintended side-effect of this has been to further compress already tight yields in China as more capital is directed

to local assets, forum participants saw few signs of any loosening of the restrictions. At the same time, however, they also noted that the rules are better seen as a short-term solution to the disorderly nature of current outflows than as part of a broader policy to curb them altogether, with Beijing apparently acknowledging that the current glut of liquidity cannot be readily absorbed domestically without creating distortions in the economy.

Meanwhile, outflows from other Asian markets continue unabated. While the United States until now has been the main beneficiary of the flood of outflows from Asia, fund managers at the forum noted a recent shift in sentiment among regional institutions in favor of European markets. One reason for this is that hedging costs for investments in Europe are now much cheaper than for those in the United States. One fund manager noted, "Koreans investing in the Eurozone can now fully hedge—if you can believe it—at 100 basis points additional yield, as opposed to cost. This is one reason why the Koreans

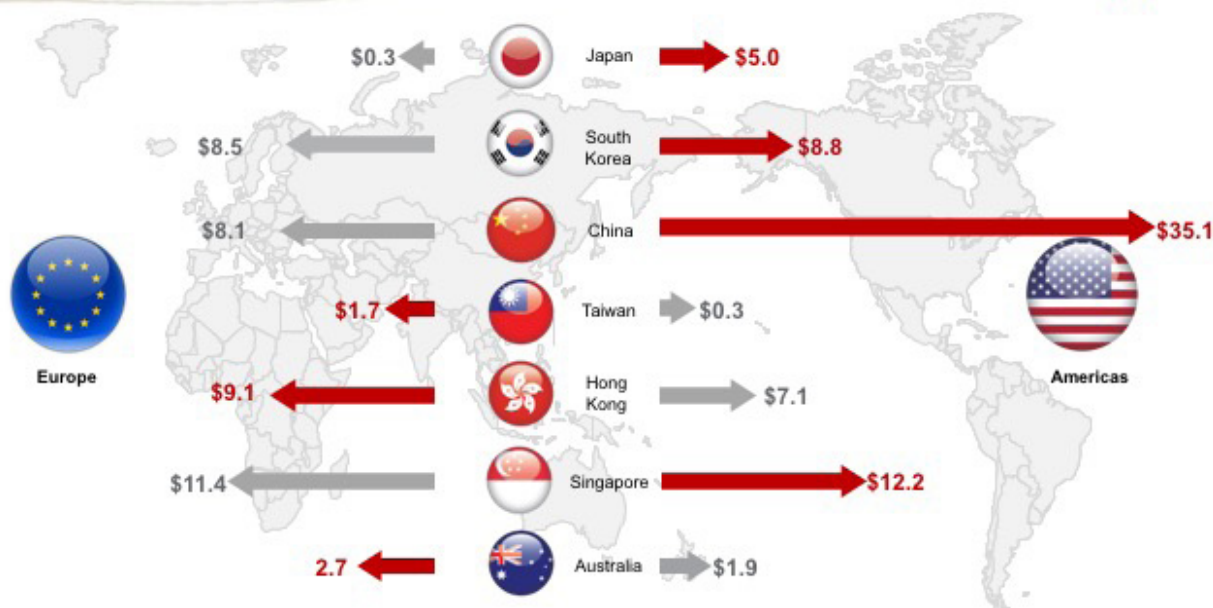
are increasingly focused on the Eurozone and less on the U.S.A."

Other factors include the higher yields obtainable in Europe, together with recent currency fluctuations in sterling and the euro that have lowered the cost of European assets for Asian investors. As one forum participant commented, "It may not be a good reason to invest, but that's what a lot of them are saying. They're thinking the pound and the euro are cheap, so this is a good time to be in those markets."

Cross-border institutional outflows within Asia, meanwhile, remain at moderate levels, even as total intraregional capital flows have grown strongly. Some participants suggested this may be about to change, but others pointed out that current transaction volumes for outbound core capital in Asia remain a fraction of those in Europe and the United States, even accounting for significant numbers of institutional investors that have opted to bypass investment funds by developing their own core assets.

Asia Pacific investors – more capital to Americas than Europe

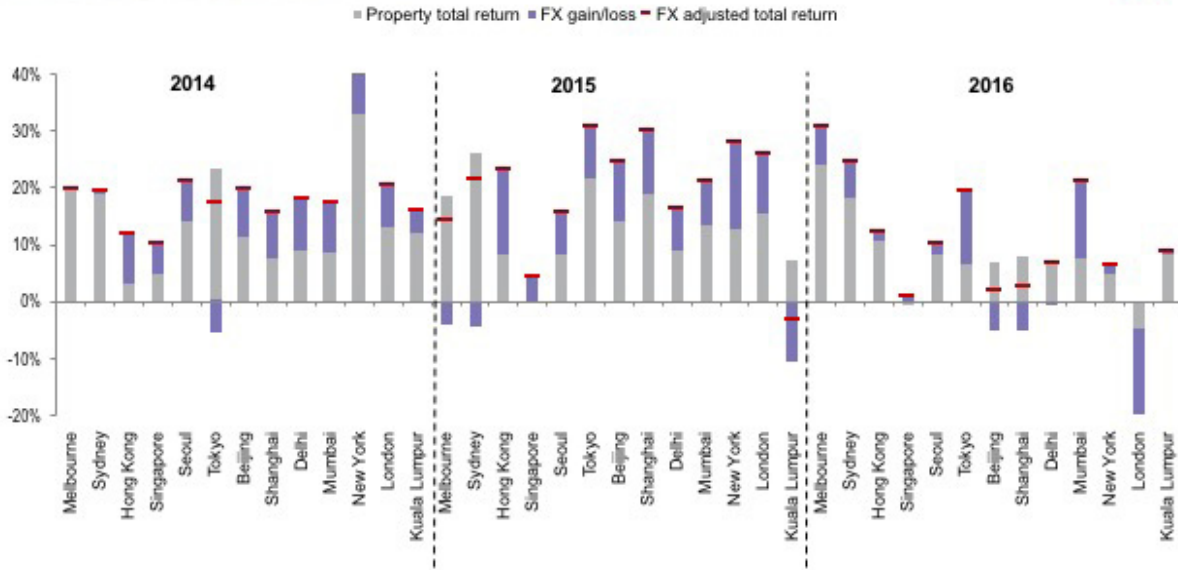
Purchaser flows, May 2015–May 2017 (US\$ billion)



Source: Real Capital Analytics, first quarter 2017.

Euro movement can affect investors' total returns

Euro investor currency-adjusted total returns, 2014–2016



Source: JLL, Thomson Reuters, first quarter 2017.

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According to one fund manager, “At the moment, most of the sponsors of pan-Asian core funds are Western institutions, not intraregional capital. When you think about the U.S.A. core universe, I would guess about 85 per cent to 90 per cent of capital going to core open-ended funds is domestic. I’d be surprised if it was as

much as 5 per cent of the Asia Pacific core open-ended funds.”

That said, however, participants were unanimous in projecting the current high levels of outflows from Asia will only increase in the future, as more institutional players in the region turn their sights away from domestic markets and as capital from

markets such as Japan, India, and Indonesia begins to join the fray. According to one forum participant, “We literally have seen just a tiny tip of the iceberg of the capital that’s going to come from Asia and into Europe, particularly.”



Growth versus Yield

While Asian real estate investors have long complained about high risk-adjusted prices, ongoing rental growth across the region has reaped investors years of outsized profits, which has, in turn, encouraged buyers to front-run the market by underwriting growth.

In fact, fund managers often have little choice but to do so if they want to participate in the market at all, given that current asking prices leave little scope for required profit margins unless they are able to raise rents significantly over time. As one investor put it, "Growth is the catalyst people have to rely on in order to make returns in the current environment."

Today, however, the focus is shifting, with investors gravitating more towards assets providing reliable yields rather than big returns. Why? Participants suggested various reasons.

First, growing numbers of institutional and sovereign players in Asian markets are looking specifically for long-term yield plays that better suit the structure of their liabilities. In addition, there appears to be



a coordinated campaign among central banks globally to end ten years of accommodative monetary policy. With higher base rates leading naturally to higher yields for sovereign bonds, there will be knock-on consequences for real estate prices valued historically by their spread to sovereign debt.

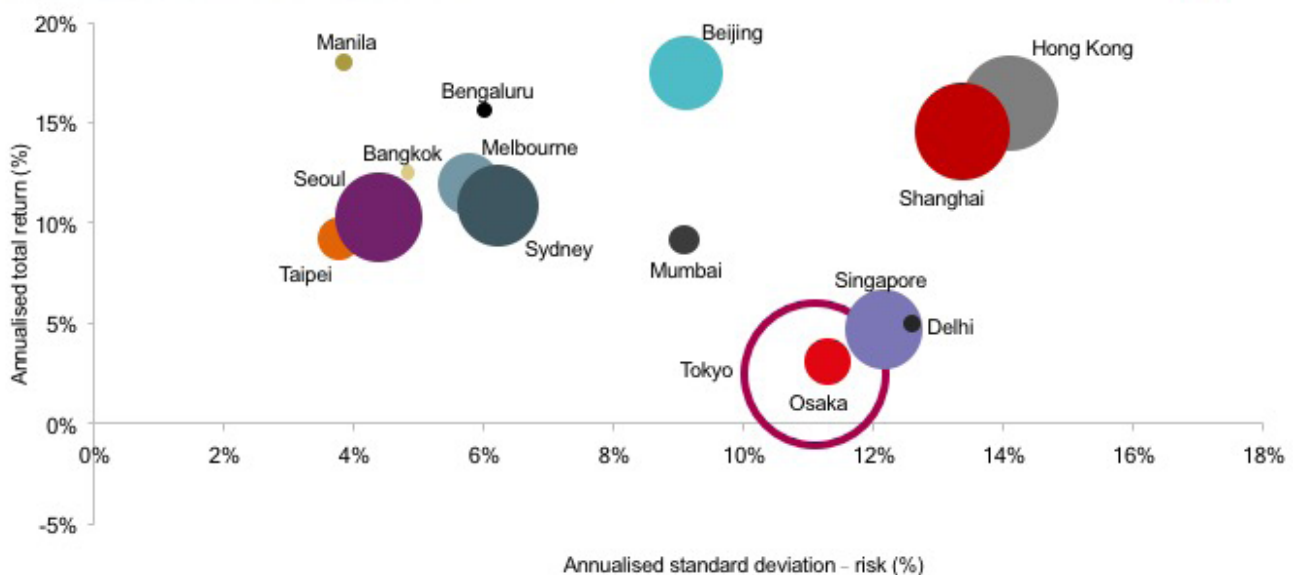
This has created a dilemma for those buying low-yielding properties in the expectation they will be made whole by rising rents. Noted one fund manager, "One of the challenges with current yields for almost any type of asset is that to make an invest-

ment with adequate returns for institutional investors, you have to underwrite some growth, so your going-in yields are very aggressive in most markets globally. But what we have found historically is that in order to underwrite significant further growth, you are obviously layering on a pretty significant amount of extra risk.

"Therefore, if the markets experience significant interest rate hikes, particularly in the Pacific, returns will disappear, either in growth not catching up with the expansion

Range of risk and return options in office markets

Prime office annualised total returns and risks, 2009–2017



Source: JLL, first quarter 2017.

of cap rates or due to the impact of rising interest rates on overall economic growth.” Another factor in the growth-versus-yield debate is that investment cycles in many markets are now getting rather long in the tooth, leaving prospects for further rent rises uncertain.

This issue was hotly contested, however. One investor pointed out that “in the end, growth comes down to the fundamentals

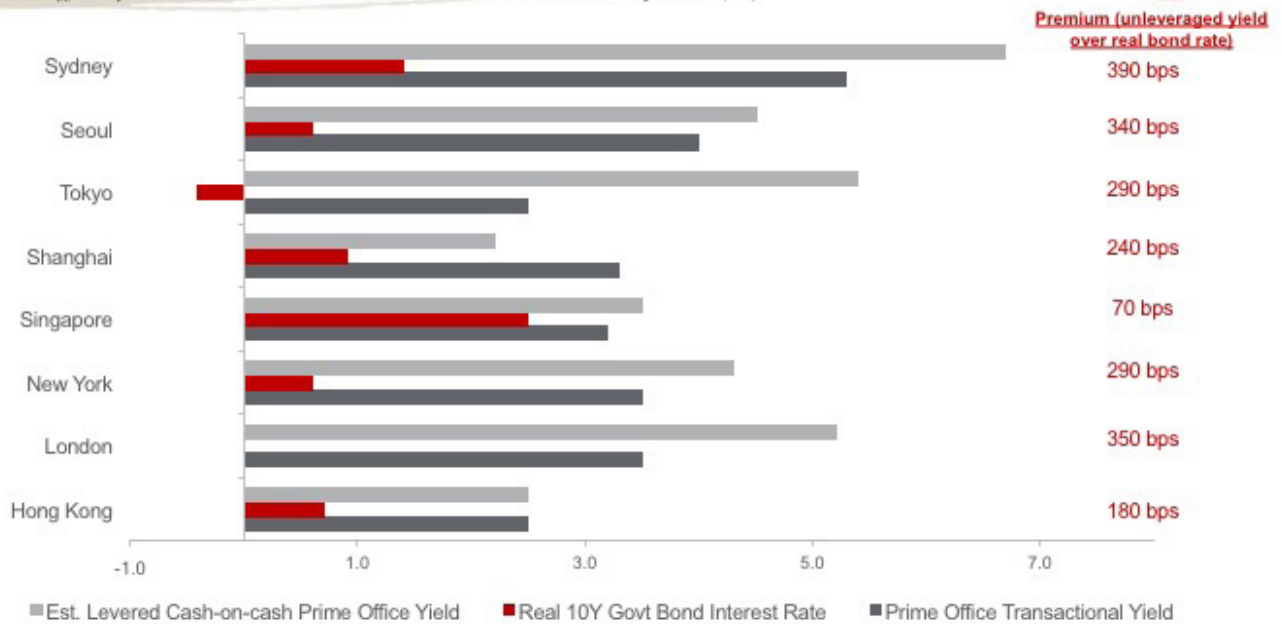
of the market, and a lot of economies seem to have fundamentals that look relatively robust. At the same time, the supply picture in the major markets looks actually within check. So once you start looking, there are still opportunities pointing to growth over time.”

Quite apart from this, concerns about the imminent demise of the rental growth dynamic have been “front and center” for

several years, while rents in general have seen handsome (and largely unexpected) increases. Sydney, for example, saw rents climb a remarkable 28 per cent year-on-year in the first quarter of this year—much higher than anticipated. India was cited as another market where strong rental growth seems likely, whereas rent prospects in Japan were considered shaky.

Real estate yield spread over bonds still wide

Prime office yields, real bond rates, levered cash-on-cash yields (%)

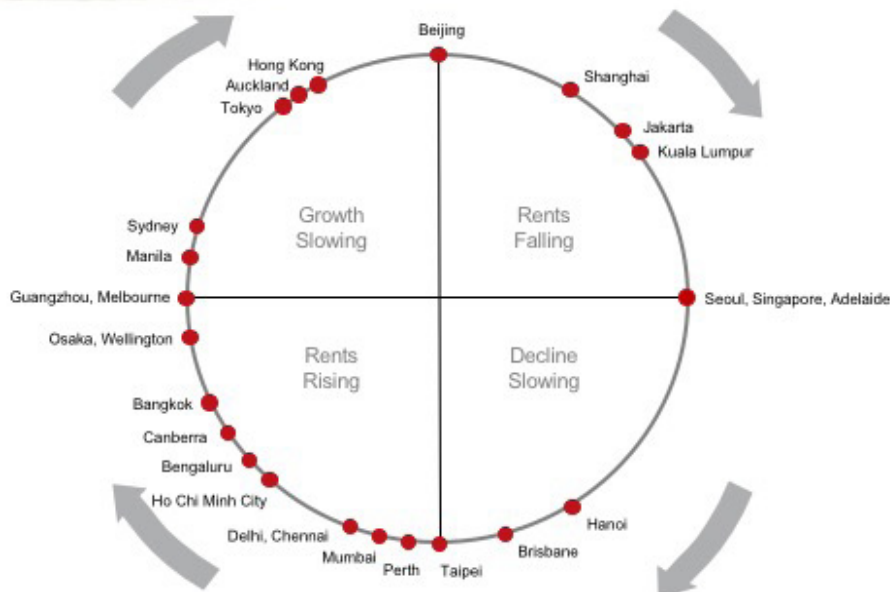


Source: JLL, first quarter 2017.

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Moderate prime office rent growth is expected

Asia Pacific prime office rental clock, first quarter 2017



*Clock positions for the office sector relate to the main submarket in each city. Source: JLL, first quarter 2017

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Innovation and Technology

The impact of new technology on global lifestyles and businesses over the past two decades has been transformative. As an industry, however, real estate is one of a minority that remains largely untouched by this revolution. Be it construction methods and materials, marketing techniques, or fit-out and use of office space, practices remain much the same as decades ago.

This is about to change, however. With a number of disruptive new technologies already impinging on business-as-usual methods and even more looming on the horizon, forum members discussed various ways in which technology is affecting the real estate status quo.

One field already making inroads on conventional business practices is artificial intelligence (AI), particularly in fast-growing customer service and information technology (IT) outsourcing industries in markets such as the Philippines and India. With



software-based alternatives now threatening job growth in this area, office space demand in industry hubs such as Bangalore and Manila may be hit as staffing requirements fall.

Nor is the AI challenge restricted to outsourcing. Over time, staffing requirements across many mainstream service-sector businesses are also going to feel the heat. As one investor commented, the growth in AI probably will result in “a large swath of white-collar

unemployment, especially in middle and back offices, including at many of the organisations we see around the table today.”

Another rapidly evolving tech theme involves changing patterns of office use. As one fund manager observed, many landlords who remain stuck in the traditional industry paradigm of large spaces and long leases are likely to be tripped up without a change in approach. “I think in order to

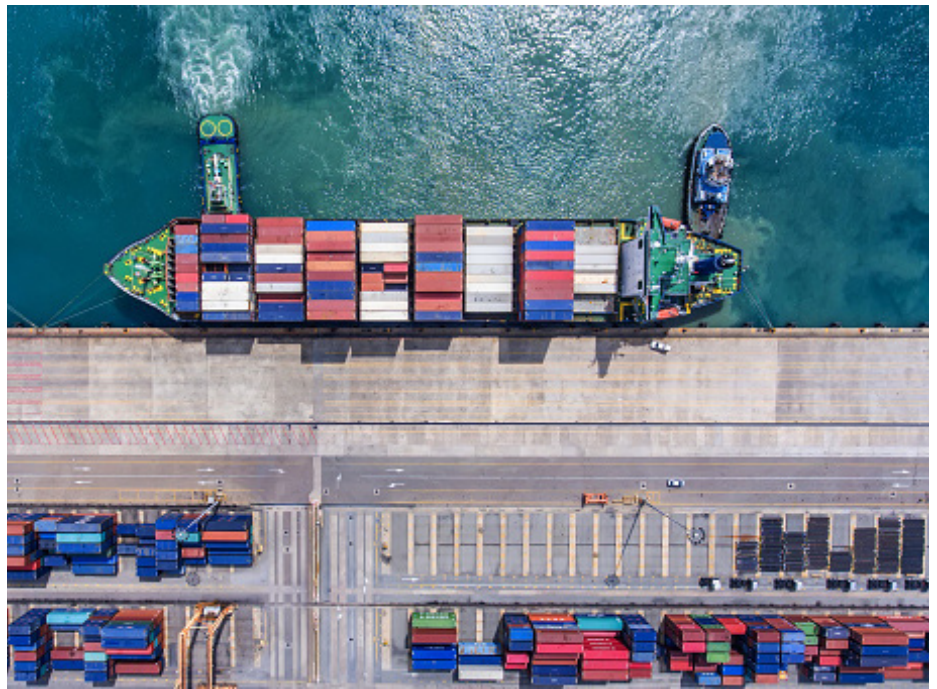


stay relevant today, we have to be able to adapt the space for a different type of use. Otherwise, you'll find you get to the end of those traditional leases without a replacement tenant and with significant empty space. Tenants are not leasing those large-lot spaces anymore. They're distributing the workforce or cutting space. Just in our small office in Hong Kong, we've tripled the number of people in the same area."

The retail sector, of course, is already in the crosshairs of online retailing as a profound and often traumatic transformation in Western markets forces the closing of thousands of suburban malls. With consumer purchasing habits continuing to shift online, similar change is now in the works for the related but less high-profile logistics and distribution sectors. Long-term job prospects for truck drivers, for example, appear bleak given fast-maturing automated-vehicle technologies, while change is also afoot in an area more directly linked to real estate: warehousing and distribution hubs.

Said one participant, "Because of data analytics, the way supply-chain networks are being set up and the location of logistics nodes are now very different. In the past, warehouses in our portfolio were about 30,000 square metres, but now tenants are looking for much larger hubs, something like 100,000 square metres. Smaller ones are now less attractive."

Rapidly evolving fulfillment needs also imply a major shift in current practices. Same-day delivery services, for example, are now a firmly established retailing trend, leading to demand for a multitude of small fulfillment hubs located in city centres and large ones in the outskirts. One investor noted that his fund had recently bought an office building in Midtown Manhattan and repurposed it as a fulfillment centre to be used by bicycle couriers, small vehicles, and people on foot, as opposed to the usual fleet of delivery or container trucks. Similar facilities are likely to mushroom over the next few years.



Looking farther ahead, logistics facilities are going to see even more profound change. One participant suggested that upcoming advances in 3-D printing technologies are likely to result in the decentralisation of global manufacturing processes. Instead of goods being shipped overseas from a small number of large dedicated factories, therefore, in the future vendors will simply ship designs to distribution hubs in overseas markets, where the product will be printed and shipped locally, thereby combining the functionality of manufacturing, warehousing, and distribution in a single location.

While investors' reactions to these impending disruptions are often reflexively defensive, the reality is that change will bring as many opportunities as challenges. It would therefore be wrong to see them as negative simply because they are inevitable.

One participant commented, "One thing that seems to be missing here is, where is tech dislocation going to enable you to have a higher cash flow? At the moment, in labor-intensive asset classes such as hotels and apartments, we're currently seeing 20 per cent to 25 per cent potential cost reductions that will go right to the bottom line just through automation. Then there's delivery of product. If we're able to put up from pad

to roof a garden community in 14 days as opposed to the usual 40, your carry load and your cost of capital come down substantially, and you're able to move to market quicker. So I think there are many ways to embrace this in portfolio allocations and to understand there's money to be made."

A final insight into this process of evolutionary change relates to speed of adoption. As one investor commented, tech revolutions tend to happen both more slowly and more quickly than many expect. "When you look back over the last ten years, people have probably overestimated the pace of short-term change—over, say, three to five years—but have also underestimated the extent of disruption over a ten-year period. And I think we are seeing this happening now. We probably overestimate the impact that automation or robotics or AI will have in the near term, but we have little real idea of how profound it's going to be over a ten-year time frame. I think it's going to be a big shift."

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