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FEATURES

DEPARTMENTS

The Asian REIT Market

Asian REITs Start to Climb Back Up the Performance Ladder

by Jennifer Molloy

The Asian REIT market rebounded significantly during the second quarter after struggling in 2008 and the first quarter of this year, demonstrating the return of some confidence to the market. However, share prices have not yet returned to the peaks seen in late 2007. With a history of less than 10 years, the Asian REIT market may be less established than its U.S. counterpart, but Asian REITs — though not without flaws — are an investment vehicle worthy of note. Even the prospect of a REIT market in China coming to fruition in the foreseeable future may give property investors additional options.

Across the board, asset classes have suffered during the global financial crisis, and global REITs have been no exception. Japan's New City Residence Investment Corp. was the first Asian REIT to falter, filing for bankruptcy protection in October 2008. Traditionally viewed as a safer, more liquid way to invest, the Asian REIT market (primarily the dominant REIT markets of Japan and Singapore followed by Hong Kong) performed well for a number of years with a significant number of foreign investors. The onset of the subprime residential mortgage crisis in 2007, however, saw foreign investors exiting the market, leading to a decline in Asian REIT performance, according to Peter Mitchell, CEO of the Asian Public Real Estate Association (APREA). In response to the current economic downturn came the establishment of government stimulus packages, recapitalization efforts by REITs and so on, leading to a much-improved first half of 2009 for REITs worldwide.

RISK AVERSION

The risk aversion brought on by the global economic crisis, however, took a toll on REIT markets globally, throwing the driving principles behind REIT investing — attractive total returns, moderate volatility, income enhancement and relatively low correlations with other asset classes — into flux.

While performance improved in the first half of the year, REITs still have some way to go to rise off of their lows and reach their peaks again, although there has been strong recovery in Singapore in recent months. "The global financial crisis has caused major value destruction in all global REIT markets," asserts Vincent Felteau, a portfolio manager with Presima. "Traditionally perceived as a stable investment vehicle being some sort of a hybrid between bonds and equities, REITs have recently traded much more in line with risky equities. Property management companies listened to investors willing to pay a premium for higher perceived growth fueled by leverage. In fact, low interest rates globally combined with appreciated property values have led to several nontraditional and enterprising ventures. Real estate companies have become even more dependent on the availability of credit due to offshore expansion, large development pipeline, fund management businesses and so on," suggests Felteau.

With increased share volatility and the convergence of REITs with other asset classes during the financial crisis, investors facing liquidity problems in their portfolios were easily able to cash out REITs, leaving the REIT market on a downward spiral, suggests David Fan, a managing director with CB Richard Ellis Investors. Fan notes, however, that this liquidity also presented real estate investors with a silver lining — all things considered — with respect to valuation. "Liquidity itself can be a positive: while [the] write-down of direct property investments is a drawn-out process, especially due to a dearth of transactions, REIT prices corrected quickly and fiercely, resulting in valuation write-down that is ahead of the private market, and in many cases implying devaluation that is potentially much greater than what will actually materialize in the direct market," explains Fan. "Another strength is that most of the REITs were more lowly leveraged relative to direct property funds to start with," Fan adds.

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— Vincent Felteau, portfolio manager, Presima

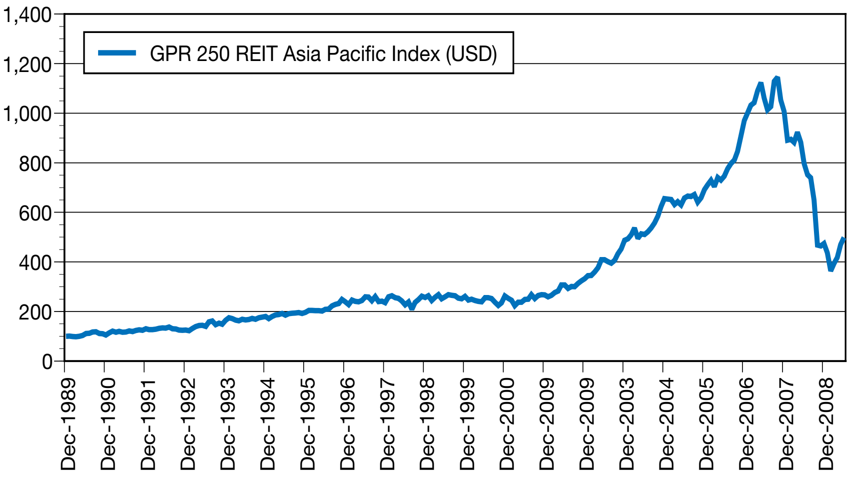
SIGNS OF RECOVERY

In fact, the positive performance of Asian REITs during second quarter 2009 compared to that of the first quarter of the year might reflect a changing attitude among investors that recovery for the sector is within reach. This news bodes especially well for investors just joining the Asian REIT market. However, Asia Pacific REIT performance is still well off its 2007 peak, leaving investors with years of exposure to the market still experiencing a loss, but perhaps now sighing with a bit of relief that the market may be rebounding (see "Performance of Asia Pacific REITs, 4Q/1989 to 2Q/2009," below).

"The psychological change from an Armageddon mind-set was an important driver behind the recent recovery, which gained steam as investors felt a bottom had been reached," says Fan. "The improved sentiment was accompanied by recovery in securities globally on signs of 'green shoots.' At the same time, financial fundamentals, that is, REITs' ability to access capital, real or perceived, indeed strengthened significantly. This formed a positive feedback loop as higher comfort levels felt by banks and investors led to higher share prices, which in turn further facilitated capital flow into the sector," adds Fan.

Total returns reflected such recovery, with 89 out of 93 listed REITs in Japan, Hong Kong, Malaysia, Singapore, South Korea and Taiwan posting positive total returns during the second quarter compared with only 50 out of 93 during first quarter 2009, according

Performance of Asia Pacific REITs, 4Q/1989 to 2Q/2009



Sources: Global Property Research

to *The Asian REIT Report,* a quarterly report produced by Institutional Real Estate, Inc. In addition, total returns in the second quarter skyrocketed, with the top six performing Asian REITs (all J-REITs) posting total returns of between 100 percent and 239 percent since the first quarter, notes the report. Despite this impressive second quarter performance, REITs globally declined during the first half of 2009 (see "Global REIT Markets Total Returns," page 10). In Asia in particular, certain factors played a role in improving REIT returns during the first half of the year.

J-REITs in particular may have benefited from the news of specific government intervention policy proposals, such as providing loans to J-REITs, especially to refinance corporate bonds, notes Felteau. "J-REITs are benefiting from a renewed sense of confidence related to easier refinancing conditions," he says. As an example, Felteau points to the Development Bank of Japan and other government organizations that have assisted funding by extending significant loans. In addition, when no alternative option is available, the Japanese government will provide loans to aid with the refinancing of loans or J-REIT mergers, but will not provide monetary assistance for property acquisitions, according to the *Fudosan Keizai Tsushin,* a Japanese industry newspaper.

However, other factors were at play in the recovery seen in the S-REIT sector, contends APREA's Mitchell. "In Singapore, the REIT market was due for a correction, and this would have happened regardless of the global financial crisis," Mitchell explains. "The REIT market had enjoyed six years of sustained growth, outperforming general equities. Whatever one's view of true NAV, it was clear that a number of the REITs were trading at unsustainable NAV premiums. The decline in the last quarter of last year was rapid and deep, to the point that many of the REITs were seen to be trading at substantial discounts. That, plus the view that it is the public markets that adjust most quickly and recover first, has undoubtedly led to recovery in S-REIT prices."

While Asian REIT prices may continue upward in the near term due to highly favorable monetary conditions, inflation ultimately may play a role in sustaining REIT prices, comments Marc-André Flageole, another portfolio manager with Presima. "Prospects for inflation are not a short-term concern in Asia, but as liquidity remains widely available, expectations of future inflation might soon be on the rise. Investors' demand for a hedge against inflation could trigger further increases in physical real estate values, which would support REIT prices."

But an eye also must be kept on weighing fundamentals and risk aversion. "A major challenge is certainly the sustainability of the improvement of fundamentals and risk appetite for real estate once monetary conditions become less favorable," adds Flageole. "We are also concerned by the rapidity at which the current uptrend is unfolding. Quick and unreasonable increases in real estate prices have traditionally led some Asian governments to intervene to slow down speculation."

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— David Fan, managing director, CB Richard Ellis Investors

REITS GLOBALLY

In addition, the economic downturn has been sending many REITs globally into recapitalization mode, via new stock offerings, in order to shore up their balance sheets and begin acquiring properties again. To this end, Asian REITs, less troubled by banking systems with frozen credit hampering their activities than in the United States and Europe, offer some advantages and disadvantages to investors by comparison.

While still in its infancy relative to other REIT markets, "the Asian REIT market is a complex and dynamic market where companies are generally better capitalized and in some instances already looking at external growth initiatives," offers Felteau, who adds that "the consumer is also better positioned to drive future demand growth considering population pyramids and higher saving rates."

But disadvantages exist as well for investors in the Asian REIT sector. "Obstacles in Asia in general would be expensive valuations for some companies and diminishing government support for the real estate sector. In the longer term, sustainability is a major risk due to a lack of transparency, a need of better governance policies and finally environmental issues in some countries," observes Felteau.

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— Peter Mitchell, CEO, Asian Public Real Estate Association

Looking at specific Asian REIT markets, Presima's Flageole sees cause for near-term optimism and concern. "In our view, Hong Kong and Taiwan indirectly benefited from the strength of the Chinese markets, driven mostly by a successful economic stimulus package and stellar bank loan growth. Singapore and Malaysia were also helped by attractive distribution yields and compelling valuation multiples. On the flipside, Japan and South Korea remain more dependent on exportations and, particularly in Japan, on the recovery of Western consumption, which has yet to materialize."

In addition, inflation, which typically aids property values, appears less likely in Japan and South Korea, in part due to decreased internal demand, mentions Flageole. But growth in general is likely to continue in the Asian REIT sector. "In the near term, as the global economic growth recovers, we could see REITs in Japan and Singapore perform well on a relative basis," notes Flageole. "Analysts' expectations for REITs' earnings and valuation multiples are mostly lower than what can now be observed in Hong Kong or Taiwan. As global trade figures start to show sustainable improvement, Japan and Singapore might benefit more at the margin.

China's REIT Future

The economic downturn has drawn attention to ongoing efforts to develop a REIT market in China. "Though China is not unscathed by the global financial crisis as the demand for commercial real estate weakens considerably in the global downturn, the crisis in actual fact highlights the importance of a REIT market in China for investors as a defensive investment, [for] developers/property owners as a new channel of funding and [for] the regulators by removing funding concentration risks from the banking sector," contends Paul Keogh, executive director of RREEF China REIT Management, which manages RREEF China Commercial Trust, a REIT listed on the Hong Kong Stock Exchange.

Keogh offers the following reasons that a REIT market in China would be well received by both institutional and retail investors:

- REITs will be a new investment product (in a market that has very limited investment channels), allowing investors to gain exposure to rental income and capital appreciation of investment-grade commercial properties at a fraction of their total cost.
- The return profile of REITs fills the void between the very conservative money market instruments/fixed-income bonds segment and the very volatile equity stock investments.
- Many institutional investors, especially regulated agencies such as pension funds, social securities and insurance companies, currently have restrictions on direct real estate investment. REITs will provide these institutions with the investment channel they need to invest in real estate.
- For retail investors, REITs provide a legitimate alternative property investment channel, compared to traditional residential investment and the higher-risk property development mutual funds.
- For developers/property owners, REITs provide a new exit strategy and a channel of raising public capital, diversifying the sources of capital and relieving the reliance of the property sector on traditional bank loans.
- The reporting requirement and corporate governance of a listed vehicle would enhance transparency, hence accelerating the maturity of the real estate market in China.

According to Keogh, "Though the structure of the China REIT regime is still unclear at this point, several key features of REITs — such as tax pass-through, allowance of investment in non-income-producing real estate, leverage cap and distribution policy — will be important regulatory considerations in the future development and attractiveness of REITs in China."

— Jennifer Molloy

We, however, remain confident about the strength of the REIT market in Hong Kong, Malaysia and Taiwan, as loose monetary policy, combined with the supportive effect of China's growth, should

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— Marc-André Flageole, portfolio manager, Presima

continue to bring liquidity and risk appetite to these markets," concludes Flageole.

By comparison, the size, liquidity and depth of the well-established U.S. REIT market can offer global REIT investors "exposure to many different subsectors throughout a large number of companies where quality, location and types of assets are unique," notes Presima's Felteau. For example, the depth of the U.S. REIT market allows Presima to have exposure to firms with laboratory space and data-storage facilities, which the company views as an advantage over other REIT markets. Although Felteau warns that the U.S. REIT market is still bogged down by a fragile banking system predominantly owned by the U.S. government, as well as a hefty amount of CMBS financing coming due within the next few years, he points out that "the recent phase of deleveraging and recapitalization is clearly a positive for the health of that market going forward."

With signs of easing credit tension in Europe, Felteau expects continental Europe "will start to show more cash flow stability due to its inflation-indexed rents. One other advantage of Europe is related to the net asset values being marked to market by third-party experts on an annual basis, therefore making the price adjustment much more rapid compared to other regions worldwide. As such, valuations are clearly starting to show signs of a bottoming in certain specific regions."

Challenges in Europe include "a significant amount of secondary assets being marketed from distressed sellers, the recent run-up in the euro currency and lastly a European Union that still seems to be struggling at unifying all of its members on a political basis," states Felteau.

THE BOTTOM LINE

Regardless of region, though, Standard & Poor's quarterly *Global Property & REIT* report noted second quarter increases of more than 25 percent in the Global REIT, Developed REIT, Emerging REIT, North American REIT, U.S. REIT, Europe REIT and Asia Pacific REIT indices, suggesting a renewed confidence in what REITs have to offer investors, especially as economies around the world struggle to recover.

Indeed, Asian REITs are popular with global investors. Approximately 40 percent of investors are actively exposed to this type of real estate investment, according to the *Investment Intentions Asia Survey 2009,* a joint study by the Asian Real Estate Association (AREA), the European Association for Investors in Non-Listed Real Estate Vehicles (INREV) and the U.S.-based Pension Real Estate Association (PREA). While REITs globally have not yet regained the performance strength demonstrated in recent years, signs of recovery are at hand. Moreover, the liquidity offered by REIT investment aids in the attractiveness of this asset class.

"Adding REITs to a mixed-asset portfolio will enhance portfolio performance through diversification benefits."

— Paul Keogh, executive director, RREEF China REIT Management

"Liquidity is one of the key advantages of REITs, but global REIT studies found that REITs performed more like a hybrid of direct real estate and listed property stocks," says Paul Keogh, executive director of RREEF China REIT Management. "Adding REITs to a mixed-asset portfolio will enhance portfolio performance through diversification benefits." ❖

Global REIT Markets Total Returns

	2Q/09	1Q/09	1 year
GPR 250 REIT Global	**22.4%**	**–24.7%**	**–38.3%**
GPR 250 REIT Americas	29.1%	–31.9%	–43.4%
GPR 250 REIT Europe	16.1%	–3.4%	–32.7%
GPR 250 REIT Asia	15.9%	–19.6%	–24.9%
GPR 250 REIT Hong Kong	16.2%	13.5%	–6.1%
GPR 250 REIT Japan	14.1%	–5.2%	–25.5%
GPR 250 REIT Singapore	27.3%	–2.9%	–33.6%
GPR 250 REIT Australia	15.5%	–23.5%	–39.7%

Source: Global Property Research

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