



Emerging  
Trends  
*in*  
Real Estate®  
Asia Pacific

2007



Urban Land  
Institute

PRICEWATERHOUSECOOPERS 



## Emerging Trends in Real Estate® Asia Pacific 2007

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Emerging  
Trends  
*in*  
Real Estate®  
Asia Pacific

2007

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# Executive Summary

Capital flows to the Asia Pacific region increased dramatically in 2005–2006, but the region remains a relatively untapped resource for institutional property investors. Many large Western investors now see real estate in the region as a must-have asset, and capital will remain in ample supply through 2007.

By source location, the United States remains a huge source of global investment capital for the region, but the largest increases in the availability of capital for real estate are expected to come from the Middle East, China, and Japan. While the flow of international capital into the region is capturing much attention, internal growth of investment capital is substantial and a major story in itself, and this capital will remain highly competitive in the market. Much of this capital is now being targeted for cross-border investments within the region as well as toward investments in the United States and Europe.

Capital is available from a broad array of source types, but private equity investment funds, institutional investors, and REITs will see the largest increases in capital availability in 2007. Many new investment products are being launched via these sources and others. Debt capital is also in ample supply.

The real estate market is becoming more sophisticated, more securitized, and more transparent, but transparency issues still abound in emerging markets in the region. Property securitization in much of the Asia Pacific region is in its infancy and will grow substantially, especially in the REIT and CMBS sectors; this trend will improve transparency and offer attractive new vehicles and options for investors.

While Asia Pacific markets offer unparalleled potential for growth, they lack depth and there is a shortage of high-quality

real estate assets available for acquisition. This limited supply, combined with growing demand for assets, has resulted in compressed cap rates across the region. With increasing flows from a growing range of sources, the market is now highly competitive and this will likely remain the case in 2007.

On the spectrum of investing in core, value added, or opportunity, core is very hard to invest in, and the latter two offer more and better options. The dearth of good investment opportunities in primary cities and sectors has resulted in more capital migrating into second-tier assets, both geographically and qualitatively.

Development is now a preferred way to invest capital in the Asia Pacific region, and many investors believe that it offers better risk-adjusted returns than core; it also allows investors to acquire new, high-quality assets on their own terms, albeit with higher risks.

The office sector remains the preferred sector for investors, as it offers the largest pool of high-quality, high-value assets; however, it is not an easy sector to invest in as it is very competitive and prices are quite high. Hotel/resort, retail, and industrial/distribution properties also offer attractive prospects.

Investors rank Osaka, Shanghai, Tokyo, Singapore, and Taipei as the top five investment markets; investors are definitely looking to buy in these cities. Strong development markets include Bangalore, Ho Chi Minh City, and Mumbai, and these cities also are high on investors' buy lists. Other solid buy cities include Guangzhou, Bangkok, Beijing, Seoul, New Delhi, and Kuala Lumpur. The relatively mature markets of Melbourne, Hong Kong, and Sydney are viewed as hold markets. Manila and Jakarta are the lowest-ranked cities in the survey.

## Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, *Emerging Trends in Real Estate® Asia Pacific* is a trends and forecast publication launched this year. The report provides an outlook on Asia Pacific real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

*Emerging Trends in Real Estate® Asia Pacific 2007* represents a consensus outlook for the future and reflects the views of more than 175 individuals who completed surveys and/or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed 48 individuals, and survey responses were received from 133 individuals whose company affiliations are broken down as follows:

Private Property Company or Developer	33.1%
Other	19.0%
Institutional Investor/Adviser	14.9%
Real Estate Services Firm	14.9%
Publicly Listed Property Company	10.7%
Government Entity	4.1%
Lender or Mortgage Banker/Broker	3.3%

A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.



# A Deluge of





*“A stream of incoming foreign capital—which turned into a flood in 2006—has swamped regional real estate markets.*

# Money Chasing Opportunity and Risk

After years in the doldrums, the Asia Pacific region’s real estate markets capped a long, slow recovery with resurgent performance in 2006. Driven by the seemingly unstoppable Chinese export engine, the Asia Pacific economies have been on fire for at least the last two years. Renewed bullishness has revved up investor expectations, newfound profits have been ploughed back into property projects, and, topping it all off, a stream of incoming foreign capital—which turned into a flood in 2006—has swamped regional real estate markets.

Despite caution at the looming implications of rising global interest rates, those surveyed and interviewed for *Emerging Trends* suggest that the music is not about to stop. But nose-bleed levels of capital flows, “an impossible number,” according to one, are expected to continue into 2007, driving down yields on investment-grade property throughout the region. As a result, investors’ biggest problem will lie in assimilating risk and reward. As a lack of supply drives them further away from their preferred investment classes, finding a productive and reasonably safe home for investment capital defines the challenge for investors in coming years.

If real estate investment in the Asia Pacific region has historically been the preserve of domestic or regional players, 2006 will go down as the year that global investors really discovered the Asia Pacific—with a vengeance. “I’ve heard people say there are \$5 chasing every \$1 of supply, and I wouldn’t disagree with them” sums up the current sentiment; investors are literally “throwing money” at the market as they line up to place funds. While the money is flowing to many countries, interviewees single out China—the growth engine of the Asia Pacific—as the favored investment destination.

## Why Is Investor Interest Growing?

Interviewees cite a number of reasons for the region’s sudden popularity among real estate investors. For one, sky-high prices and increasingly compressed yields in U.S. and (more recently) European markets are causing funds to flee to the Asia Pacific

region, where the grass is perceived to be greener than it is at home. “It’s a joke, everyone is going to everyone else’s backyard,” one analyst commented. This rush to new pastures reflects, fundamentally, the current abundance of liquidity in global markets, with more cash available for investment than good places to invest it. On the other hand, it is also true that the Asia Pacific region remains a relatively untapped resource for institutional property investors, with a much smaller proportion of the region’s total property assets held by institutions than in either Europe or the United States. This fact has certainly played a part in drawing a large volume of investment flow.

Another reason for the recent popularity of Asia Pacific real estate among international investors is that institutional portfolios are rerating property as an asset class. Funds that in the past carried property weightings of 5 to 10 percent are now attempting to boost their holdings to the 10 to 20 percent range—a testament at least partly to the extent that real estate has outperformed other asset classes over the last five years or so. As a result, interest in real estate assets generally has increased. In the Asia Pacific region, the impact of this trend has been amplified by demand for higher returns and greater diversification among Western pension funds, which are faced with the prospect of increased redemptions as a result of demographic changes in many Western societies, as the baby boom generation lines up for retirement. Rightly or wrongly, many foreign fund managers believe the Asia Pacific markets will offer them the higher returns they seek.

In addition, many large Western companies now see the Asia Pacific region generally, and China in particular, as a “must-have” market. According to one property consultant, “Every major institution has been told at board level they must focus on Asia and especially China, so every regional director is being pushed by their board to show their company is active there.”

### Exhibit 1-1 Real Estate Transparency Scores—Asia Pacific

Transparency Level	Country	2006 Transparency Score	2004 Transparency Score	2006 Tier	2004 Tier
Highest	Australia	1.15	1.19	1	1
	New Zealand	1.20	1.19	1	1
	Hong Kong	1.30	1.50	1	2
	Singapore	1.44	1.55	1	2
High	Malaysia	2.21	2.30	2	2
	Japan	2.40	3.08	2	3
Semi	Taiwan	2.86	3.10	3	3
	South Korea	2.88	3.36	3	3
	Philippines	3.30	3.43	3	3
	Thailand	3.40	3.44	3	3
	India	3.46	3.90	3	4
Low	P.R. China	3.50	3.71	4	4
	Indonesia	3.90	4.11	4	4
Opaque	Vietnam	4.69	4.60	5	5

Source: Jones Lang LaSalle, LaSalle Investment Management.

Add to this mix the impact of the “starter fund” mentality, as another investor called it. “So many banks look at each other these days and say, ‘How can we make money? Oh, we’ll start property funds.’ They all have them, every bank you can think of.” Fees earned for raising and managing money make the funds a generally profitable exercise for banks, but the phenomenon has also added a lot more money to the overall cash-flow pie. And because China is the flavor of the moment, many of these funds have rolled up indiscriminately at the mainland door. “You have to remember that what’s driving this is that people have money and they sit back and say: ‘Go get me a piece of China, I’m not interested in the details, just get me a piece.’”

And finally, the transparency of real estate markets in the Asia Pacific region is improving, with better and more reliable information providing greater comfort and reduced risk in many of these countries. Of the 14 countries assessed by Jones Lang LaSalle in a recent report, 12 showed improvements in transparency over the past two years; six of these are now rated high or highest on the transparency scale, and five others are considered to be semitransparent (see Exhibit 1-1).



## From U.S. Funds to Petro-Dollars to Local Money

The largest foreign source of cross-border investment capital for Asia Pacific real estate has come from the United States, according to data from RREEF and Jones Lang LaSalle, with some 59 percent of recent transactions coming from U.S.-based sources. However, these U.S. funds draw capital from other parts of the world, and it is increasingly more difficult to identify the true sources and flows of capital, as funds incorporated in a given jurisdiction may receive their money from investors anywhere in the world. Much of the money received by large investment banking funds may come from offshore banking centers, where beneficial ownership can be shielded by a trust or some other legal entity. In addition, a lot of capital circulating in these venues is truly international in the sense that it has been invested offshore for so long there is no real nexus to any particular jurisdiction.

But it is clear that the landscape is shifting with the entry of new investors, especially from the Middle East, and growing internal wealth and capital coming from within the region. Investors from the Middle East are the “new kids on the block.” Historically, Arab money has been directed at the bluest of blue chip investments in the U.S. and European property markets. More recently, though, as Western markets have become saturated, regional stock markets in the Middle East have collapsed, and the incoming flood of oil-buying dollars continues, Middle East investors have turned their attention to Asia Pacific assets. *Emerging Trends* survey results suggest that Middle Eastern money will be the fastest-growing source of capital for Asia Pacific real estate in 2007. Although much of this oil cash arrives as a component of opportunity or investment bank funds, an increasing amount is now coming through the front door. And no one sees the well running dry soon. As one analyst put it: “You haven’t seen anything yet. The [Middle East] money is really starting to come now and it’s not going to go down, they have to get it out the door.”

Domestic and regional players are also competing strongly for deals in their own backyards. They can offer heavyweight competition to foreign funds in any number of ways: their experience in getting deals done in cultures that are often quite alien to newly arrived Westerners, their ability to assess and defray risk in their own markets, their political and commercial connections, and—often enough—in the volume of capital they have to deploy, which has mushroomed as of late as Asia

Pacific economies have finally shaken off the lethargy of the bleak years following the Asia Pacific financial crisis in 1997.

Although the Asia Pacific region boasts many wealthy low-profile private investors who tend to fly below the public radar, Hong Kong and Singapore developers are historically the main regional players. They have plenty of cash to burn and today are focused on markets outside their own backyards, where the lack of development opportunities in a crowded marketplace offers little prospect for good returns. While they continue to have a heavyweight presence in southeast Asia, their attention today is fixed mainly on China, where their longstanding (and at first dismal) track record as foreign investment pioneers today leaves them well positioned to reap handsome dividends as they cash out of existing projects and reinvest in new developments, leveraging their profits, their *guanxi* (local connections), and their hard-earned market savvy to position themselves as the local market reaches a new threshold of maturity. The level of their commitment is reflected in higher spending. In 2005, the four most active Hong Kong developers in China collectively invested \$3.4 billion on total gross floor area of 9.93 million square meters, up from about \$1.2 billion the previous year.

## Not All Investment Is Incoming

While the Asia Pacific region is well known today as an important destination for incoming real estate investment, the traffic is not all one way. In fact, the second-biggest flow of global real estate capital in 2005—some \$11.1 billion, according to Jones Lang LaSalle—was from the Asia Pacific region into the United States. This capital flow remains strong in 2006, but is now focused on European markets. This apparently odd phenomenon is in large part attributable to the nature of Australia’s government-mandated national pension scheme, which compels employers to contribute an amount equivalent to 9 percent of workers’ wages to retirement funds, many of which are then packaged into real estate investment trusts (REITs), or listed property trusts (LPTs) as they are known in Australia. “It creates a huge flow of capital into real estate—Australia is just overflowing with it,” said one analyst. With LPTs now representing some 10 percent of the capitalization of the Australian stock market, the trusts are running out of local assets to buy. The huge flow of outgoing capital is therefore a reflection of trust managers looking abroad to find new places in which to invest funds.

Exhibit 1-2

### Portion of Survey Respondents' Global Real Estate Portfolio in the Asia Pacific

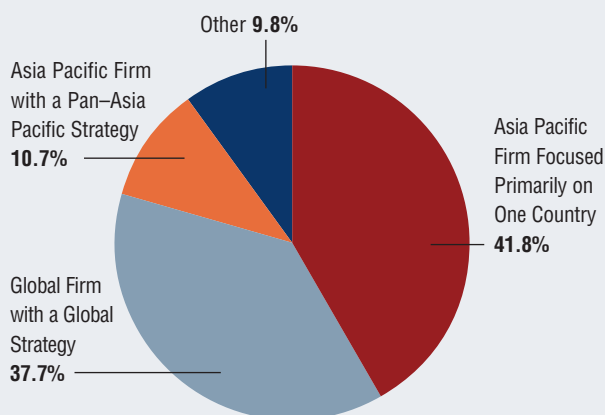
Portion of Global Portfolio in the Asia Pacific Region	Today %	Expected in Five Years %
Small Part (<25%) of Portfolio	50.8	41.7
Substantial Part (25–75%) of Portfolio	6.2	21.7
Large Part (>75 %) of Portfolio	43.1	36.7

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

But other Asia Pacific investors will likely be looking to diversify into the United States and Europe as well. The *Emerging Trends* survey found that, over the next five years, the percentage of Asia Pacific investors with most of their assets in the Asia Pacific region will be shrinking, as many of these local investors seek to diversify their investments into other regions (see Exhibits 1-2 and 1-3). Similarly, those investors with small parts of their portfolio in the Asia Pacific region are expecting to increase their allocations to the region, according to the survey. The bottom line is that investors of all stripes are seeking to diversify globally.

Exhibit 1-3

### Survey Responses by Geographic Scope of Firm



Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

## Too Much Too Soon?

The huge glut of newly arrived cash has consumed prime real estate assets in the Asia Pacific—and in particular Chinese—markets like “a plague of locusts.” The big problem for the newcomers, though, is that while Asia Pacific markets do have unparalleled potential for growth, for the most part they also lack depth. And in the absence of a solid base of investment-grade property to absorb current levels of incoming capital, too much money chasing too few assets has been a catalyst for a familiar story of overbid assets, declining returns, and ever-compressed yields. “The problem is the sheer volume,” “Demand is far greater than available supply,” “Yield compression is reflecting a lot of players chasing a limited number of assets” are common observations made by investors and analysts. There are simply not enough good-quality assets to go around. The abundance of blind funds that “raise money and then go shopping” means that “people are moving to the edge of the value and quality range. This creates a market of irrationality and adds to risk of overheating of the market.”

Profit expectations, at least in emerging markets, tend to be overambitious, too. When large numbers of foreign funds began arriving in China in 2005, interviewees report initial expectations of internal rates of return (IRRs) in the region of 30 percent net. Predictably, these failed to materialize and expectations have now slipped to the 20 percent-plus range, a figure that is probably typical in other developing Asia Pacific markets, too. Many consider this still too high. “I think 10 to 15 percent is more realistic,” said one China-based consultant, “and whether that fits their expectations I don’t know, but they tend to be optimistic about their growth estimates. That’s OK if you buy the right thing—if it’s in the right place, say, downtown Shanghai, you’ll do really well. But there aren’t many of those and there are a lot of places that people might think are like that and they’re really not.” *Emerging Trends* survey results suggest that current targets for total annual returns range from 12.5 percent for core investments up to 23.9 percent for opportunistic investments (see Exhibit 1-4).

Whether they are too high remains to be seen, but an upturn in the region’s most important economy—Japan—suggests some room for optimism. A mixture of strong economic growth, an end to deflation, and the fact that, by Japanese standards, its markets are coming off a very low base has boosted investor interest in property assets from Tokyo to Osaka to Fukuoka. Yield compression has reduced JREIT dividends to

Exhibit 1-4

### Target Total Annual Returns for Asia Pacific Real Estate Investments

	Average Return	Median Return
Core Investments	12.5%	10%
Value-Added Investments	16.9%	15%
Opportunistic Investments	23.9%	20%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

about 3.5 to 4 percent currently. This may be nothing to write home about, but the local market is becoming increasingly mature and transparent, and investors there are now looking beyond yields. With vacancy rates falling and the economy expected to show continued strength, “the key now is growth on the revenue side, which we haven’t seen yet.” In addition to higher rents, investors are also hoping for capital gains increases, especially in Tokyo.

Although factors that shape markets in Japan do not necessarily influence events in other regions, a resurgent Japanese market is a positive sign: “Japan is in recovery and normally when Japan goes well, everyone goes well in the Asia Pacific.” Besides, the sheer size of the Japanese property sector—by far the largest in the Asia Pacific region—makes it a magnet for those struggling to deploy their funds. “They have to get it out or they have to give it back. And if you do a deal in Japan, it’s going to be huge because nothing is under \$100 million—one deal in Japan is probably like four anywhere else.”

That said, foreign investors may still find they have problems closing deals in this market because of competition from capital-rich Japanese players that have recently emerged from a ten- or 15-year hibernation period and have modest expectations when their alternative is 1.8 percent on a Japanese government bond. “I wouldn’t get very excited about it because I think you won’t get in,” said one analyst. “It’s just very competitive and the Japanese are backing their own market—it was easier two or three years ago.”

## Second Tier, Not Second Class

The dearth of good “glass-box” investment opportunities in first-choice locations has resulted in more capital migrating—by necessity—into second-tier assets, both geographically and qualitatively. This concept is nothing new to Hong Kong and Singapore developers, who have been doing it in the Asia

Pacific region for years. In China, more than 75 percent of Hong Kong developer investments in 2005 were devoted to (mainly commercial) projects in secondary locations that most people in the West have never heard of—often in cities located deep in the interior, such as Chengdu, Chongqing, Wuhan, and Changsha. With IRRs supposedly running at 25 to 30 percent, these markets offer the kind of potential that has drawn foreign opportunity funds to the Asia Pacific region in the first place.

They are not for the faint of heart, however, and investing in development deals can be particularly risky. For one, second-tier markets are particularly opaque. As one consultant observed: “The guy running the city is the guy related to everyone else. In a culture where relationships are everything, how can an outside party come in and get access to a prime piece of land where five generations of handshakes have gone through on that block?” Besides this, very few of these opportunities are investable and therefore involve sometimes significant development risk. For most newcomers, they are a step too far. According to one consultant, not only do they lack market knowledge, foreigners just don’t have the manpower: “A lot of the international fund teams in China are less than five people—you’re not going to be able to get into the development game with that kind of team.”

For now, therefore, second-tier destinations remain beyond the reach of all but the most experienced—or daring—foreign investors, meaning for the most part large international investment funds. One recent trend has seen foreigners team up with local players, with some funds taking equity stakes. Both sides benefit in different ways: local developers get access to ready cash in what is fast becoming a capital-deprived domestic investment environment, while foreigners benefit from local market knowledge and contacts, an asset whose value is often underestimated in the region’s relationship-driven cultures.

India offers several second-tier markets that are on many investors’ radars, and Ho Chi Minh City in Vietnam is attracting interest, too. Despite the hype, however, foreign investor deals in these locations remain relatively thin on the ground, a result due in large part to seemingly endless volumes of red tape and other regulatory problems. Although booming fundamental demand and a very low base of existing investable stock make for high development potential, expectations for returns are similar to those in China, and most believe that for the time being, Indian and Vietnamese markets remain too difficult to negotiate.



## Products and Niches

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The office sector offers the best investment prospects for 2007, according to the *Emerging Trends* survey, followed by hotel/resorts, retail, industrial/distribution, homebuilding, and apartments residential, in that order. Shortage of supply and compressed yields in more conventional investment products—such as office and retail—are leading to increased interest in other property types across the region.

Hotel construction has taken off, driven by improved operational performance, growing demand, and low cost of debt. China, unsurprisingly, is the leading hotel development market, hosting 188 projects, or almost half of all development currently underway in the Asia Pacific region in mid-2006, according to Lodging Econometrics. It is followed by India and Thailand. Notably, the former Portuguese colony of Macau in China, located near Hong Kong, has impressively emerged as a major new tourist destination. With investment coming from mainly U.S. gambling-oriented resort developers, the city overtook Las Vegas in 2005 to become the biggest gambling destination in the world by revenue.

A buoyant hotel transaction market is expected to continue in 2006, especially in Japan, where a new impairment valuation rule came into effect in March 2006, forcing owners to write down property values to market levels. The new law is expected to result in new opportunities for foreign investors in Japan's hotel sector, led mainly by U.S. private equity and opportunity funds. Japanese banks are also offering attractive financing packages. REITs have not been a big factor in driving hotel or niche markets generally in the region, as their interest remains focused primarily on the office and retail sectors.

Logistics parks are another growing major sector in the Asia Pacific region, mainly a result of the region's huge export economy. China, as the "world's factory," has the greatest need for such facilities, and the market there is exploding, helped along by regulatory reforms introduced at the end of 2005 that now allow virtually unrestricted foreign investment in Chinese logistics enterprises. That said, investment in the sector is high throughout the Asia Pacific region. As one Chinese-based logistics investor said, "Compared to Japan, we're a minnow. They just make more noise about it in China."

Health care tourism has become a popular niche in Thailand, Malaysia, and Singapore, driven by the low cost of health care compared with the West. It is also a common perk in Middle Eastern paypackets, with many governments and large companies offering health plans with care facilities provided in southeast Asia. This market has also driven demand for associated forms of residential accommodation and senior citizen assisted-care property, some of them associated with timeshare properties. One interviewee stated that he was working with provident funds from Japan, Korea, and Taiwan supporting retirees wanting to move to southeast Asia from their home countries. China is also touted as a destination with huge potential for health tourism. In addition, demand is emerging for retirement home developments catering to the domestic market.

## REITs Have Arrived

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At a market capitalization of \$346 billion, the listed property sector in the Asia Pacific region is quite large, exceeding the size of Europe (\$211 billion) and rivaling that of the United States (\$407 billion), according to S&P/Citigroup Broad Market Index. REITs are a relatively small segment of the listed property sector in the Asia Pacific region—with a total market capitalization of \$117 billion as of July 2006—but they are growing fast and thus receiving a lot of attention (see Exhibit 1-5). With the notable exception of Australia, whose \$77 billion market for LPTs has been active since the early 1970s, REITs are a relatively new phenomenon in the Asia Pacific region. Since their debut in Japan in 2001, however, the market has grown rapidly. Listed REIT sectors are now operating in many of the Asia Pacific region's mature and semimature markets, including Singapore, Hong Kong, and Taiwan, and they are surfacing in other countries as well, including Malaysia, Korea, and Thailand. By the second quarter of 2006, Asia Pacific REITs (except Australia) sported a combined market cap of some \$40.9 billion (with more than 64 percent of these assets held in Japan) and much more in the pipeline.

Interviewees have observed that in markets where "traditionally, governance and structure [are] not very transparent," the Asia Pacific REITs have brought a measure of discipline to an environment in which the property sector has always tended to be something of an "exclusive club." They have also served to reduce overall risk to economies that are sometimes dangerously

leading to increased interest in other property types across the region.

Exhibit 1-5

### BMI (Broad Market Index) Listed Property and REIT Indices

Country	BMI Total Property Market Cap U.S. MM \$	BMI Total REIT Market Cap U.S. MM \$
World	964,771	558,833
North America	407,442	384,981
Asia Pacific	346,233	117,025
Europe	211,097	56,826
Hong Kong	122,885	6,387
Japan	113,469	26,372
Australia	84,580	76,909
Singapore	23,571	5,629
China	20,793	0
Taiwan	5,243	804
Philippines	4,094	0
Malaysia	2,982	0
New Zealand	1,728	1,728
Thailand	981	0
Indonesia	746	0
South Korea	0	0
India	0	0

Source: S&P/Citigroup Global Equity Indices. Closing \$US weights, values for July 25, 2006.

exposed by frenzied investment in property assets by shifting the onus for financing many real estate transactions, either directly or indirectly, from banks to shareholders. As a result, the opportunity to invest in Asia Pacific property by way of locally listed REITs is helping stimulate rapid evolution of regional real estate markets and is expected to encourage more international investors to participate in the region, as it has already in Japan.

In fact, so compelling are the arguments in favor of the Asia Pacific REIT model, there is a risk it may be a victim of its own success. Perhaps with an eye to the REIT market in Australia, where LPTs now own a staggering 49 percent of the nation's investment-grade property, one Singapore-based analyst pointed out that in markets where investment-grade resources are thin on the ground, competing REITs would muscle out the other players, stripping the market of assets and diluting its profits: "REITs don't encourage as much competition as when the market was more fragmented. The U.S. has a huge market and we don't, so we've quickly seen yield compression."

Investors are also looking to adapt the REIT model to emerging markets. Rumors are rife, for example, that India may introduce REITs in 2007. The main interest, however, is again in China, where local developers who have historically operated on an "asset-light" model, with relatively little development capital, are being squeezed by new rules restricting bank lending to property projects; these developers are desperate—except for the largest players who by and large are already listed—to find cash anywhere they can. Foreign investors also see REITs as a prime exit mechanism for their China projects. Both groups will need to be patient, however. Chinese law continues to impose tight restrictions on domestically created REITs that prevent them from being a significant force in the market.

Despite the fact that REITs would ostensibly inoculate the domestic banking sector from property market meltdowns, local regulators cautious of new investment vehicles in the wake of numerous financial- and property-related fiascos of the past seem unlikely to unleash REITs on Chinese stock markets for at least several years yet. As one Shanghai-based consultant observed: "The quality of the underlying assets is the issue. The temptation for a REIT is to bundle up low-quality assets and try to fob those off on a retail investor. That's the key concern and will give [regulators] worries as they move forward." As a result, REIT activity in the mainland is likely to be restricted to those able to list holdings on foreign exchanges, in particular Hong Kong, which listed the first China-property REIT (known as the GZI REIT) in early 2006. More are expected to follow.

## Changing Asia Pacific Economic Risks

Pulled along by the immensely powerful Chinese economic engine, gross domestic product (GDP) growth in Asia has been extremely strong (averaging about 4.5 percent) over the last couple of years, as the laggards finally shrug off lingering hangovers from the regional economic and currency crises that surfaced in 1997. That dynamic showed no sign of slowing in the first half of 2006—in fact, the economic action in China seems stronger than ever, averaging 10 percent according to official

**Exhibit 1-6 Asia Pacific Economic Growth Trends**

	Real GDP Growth Rate (%)			
	2004	2005	2006*	2007*
Asia	4.5	4.5	4.5	4.1
Oceania	3.6	2.5	2.7	3.2
China	10.1	9.9	10.0	9.3
India	7.5	7.9	6.8	6.8
Singapore	8.7	6.4	6.3	6.4
Indonesia	5.1	5.6	5.5	5.9
Thailand	6.2	4.4	5.6	5.5
Malaysia	7.1	5.2	5.8	5.3
South Korea	4.7	4.0	5.2	5.3
Philippines	6.0	5.1	5.4	5.1
Hong Kong	8.6	7.3	5.2	4.6
Taiwan	6.1	4.1	4.9	4.4
Australia	3.5	2.6	2.9	3.3
New Zealand	4.3	2.0	1.6	2.4
Japan	2.3	2.6	2.3	1.7

Source: Moody's Economy.com.

\*Projections.

figures, with some analysts believing these to be low-ball figures (see Exhibit 1-6). With some reservations, the consensus among interviewees was overwhelmingly bullish. All things being equal, they say, the Asia Pacific economies should continue to motor ahead, if at a slightly diminished pace from the current pedal-to-the-metal pace.

In the Asia Pacific region, however, all things are not always equal. Economic fallout has a habit of lurking around the corner in a part of the world long subject to the consequences of upheavals ranging from public health disasters (the SARS epidemic), economic crisis (the 1997 currency meltdowns), and potential geopolitical conflict (North Korea, Taiwan). There remains no shortage of risks that might upset the applecart in the future as they have in the past.

The most commonly expressed concern is that, with so many Asia Pacific countries directly or indirectly reliant for their economic well-being on American spending, a consumer-led slump in the United States might have exponential repercussions on local economies that cannot punch the same weight. "Singapore is small, so we are very [affected] by externalities such as what's happening in the U.S. economy and in the region, too." In addition, there was a predictable level of anxiety about the specter of rising international interest rates

draining off the liquidity that has been a major contributor to booming property investment. "Economic or political problems that reduce current levels of liquidity could [affect] the local markets quite severely." "As interest rates rise in the U.S., the liquidity of the market will dry up." On the other hand, not everyone was worried: "I don't think that a slowing America matters as much as five years ago because the economies here are so much more developed and bigger than they were."

The dangers of an Asia Pacific region liquidity squeeze may be hard to imagine, given the huge volumes of cash that have appeared in the region over the last couple of years. Most interviewees see no prospect of a dramatic decline in capital flows: "In the next 12 months, I see as much capital, at least as much." And some believe that petro-dollars from the Middle East will continue, even if the Fed turns off the spigot in the United States. "More oil money, and more money next year than this." "Higher oil prices are the joker in the pack, because even if the Western economies dry up, the money is still going to come pouring out of the Middle East."

However, feast or famine scenarios are not uncommon in the area's economic history. In addition, the speed of the current cash buildup flashes warning lights, underscoring both the unpredictability of regional economic currents and how quickly emerging imbalances can appear. Economists pose a number of scenarios that envision a whiplash effect, with liquidity leaving the region as fast as it appeared. One school of thought suggests that the recent boom is the result of the region's economies juiced by a flood of Western pension-fund money, part of "one of the most powerful liquidity waves in history," as Morgan Stanley economist Stephen Roach has called it, fleeing single-digit profits offered by Western markets in search of higher returns demanded by a demographic of baby boomer retirees. With herd-mentality "hot concept" investment funds joining the chase, tens of billions of dollars have been funneled into the Asia Pacific markets—real estate and otherwise—fueling bank credit, corporate earnings, and asset prices—a liquidity bubble, in other words, that could burst or simply deflate.

## The Big Question: Chinese Stability and Property Risks

A significant macro risk for regional property markets lies in potential instability in the Chinese economy generally, and its property sector in particular. GDP growth hit 10.3 percent as



of the first quarter of 2005, well above the government target. Exports have continued on a tear, tripling between 2000 and 2005. After 25 percent year-on-year growth in the first quarter, they now represent a heady 34 percent of GDP. The proceeds of China's ever-growing trade surplus, piled on top of a wave of foreign investment dollars seeking, among other things, an easy trade based on expectations of future appreciation in the value of the Chinese currency, the renminbi (Rmb), have been translated by Beijing's tightly managed currency float into a potentially explosive buildup of foreign currency reserves. Much of this cash, in the absence of a properly developed domestic bond market, has overflowed into the general economy and in particular into fixed-asset investments.

Although always a dominant component of Chinese GDP, investment looks set to surpass \$1.3 trillion in 2006, or more than 50 percent of national GDP, an astonishing level by any standards. Bank lending has also been pumped, seeing 80 percent year-on-year growth in the first five months of 2006, with the property sector, predictably, one of the biggest recipients. Real estate investment in China rose 23.6 percent in 2005 to Rmb1.48 trillion, following a 28.1 percent rise in 2004, according to official figures. A raft of market-cooling measures introduced by Beijing have put barely a dent in investment growth, which surged a further 21.8 percent year-on-year in the first five months of this year, and appears generally impervious to government regulation. Indeed, by the end of 2005, the Chinese real estate sector had grown to 8.6 percent of the economy, up from just 4.9 percent in 2000. At the current rate, it is expected to reach fully 9.3 percent by the end of 2006. This means, according to Morgan Stanley, that China's economy is now "more dependent on property than any economy in modern history."

The risks from these economic problems are twofold. First, there is the general possibility that the Chinese economy will suffer a hard landing unless the government is prepared to take more forceful action to deal with these and other problems. More particularly, though, China's property sector may blow up. Apart from surging investment, analysts point to rapidly rising prices, especially in big cities. In Shanghai, for example, property prices have risen 100 percent since 2000, and by even more at the high end of the market, often as a result of speculative activity. In addition, they point to market distortions and imbalances. Developers hoard property (often illegally) in land banks as they wait for land prices to rise, while at the same time a shortage of property being released on the market is contributing to the increase in prices. In addition, in the residential

market, developers build too many high-end properties unaffordable for the majority of Chinese and neglect the lower end of the market, where most demand exists (investment in low-cost housing, for example, rose just 3 percent year-on-year in the first quarter of 2006). As a result, residential vacancy rates nationwide are sky high. An official 123 million square meters, or 26 percent of new property nationwide—double that in the big cities—was unoccupied in the first quarter of 2006, a rise of 24 percent year-on-year.

A collapse of the Chinese property market would obviously be bad news for local developers and investors. But its impact would probably not be confined to China's borders. With at least 50 percent of property financing in China coming from state-owned banks, a collapse would likely devastate the already precarious domestic banking system, just as it did during the last Chinese property market meltdown in 1996. This again raises the prospect of a hard landing for the overall economy. In addition, though, because the mainland has been the lynchpin of economic growth throughout the Asia Pacific region for the last several years, the repercussions of such an event would be felt across the region. China accounted for some 30 percent of the export growth of the other eight major east Asian economies in 2005, according to the World Bank (even more in some countries, such as Japan and Korea), absorbing their output of components and raw materials to feed its manufacturing base. Strife in China therefore threatens to have a domino impact on other economies throughout the Asia Pacific region, with a knock-on impact for property markets regionally.

This is not to say, however, that such a pessimistic scenario is certain, or even likely. In fact, most interviewees with experience in Chinese real estate believe the overall market is not on the edge of a major correction, citing continuing real demand caused by an emerging middle class and China's rapid ongoing urbanization. They point out that predictions of a bursting bubble in China's property sector have proved baseless for at least the last four years, with the market seeming to take another leg up each time an analyst is wheeled out to make another apocalyptic prediction. They may be right in that, but with more and more economists now calling for an impending economic shakeup in China, the point must be moot. Property market bubbles can take years to burst. All eyes, therefore, remain on the mainland to see how the situation will play out.

## Judging Country and City Risk

In addition to financial and macroeconomic risks, investors in the Asia Pacific property sector must also judge and assimilate a high degree of market risk. The huge diversity across the region in terms of market maturity, economic development, cultural background, and government openness to foreign investment makes judging potential risk of any given investment a challenging task. Australia’s property sector, for example, is essentially as mature as any in the West. Backed by a common law legal system that is both predictable and well understood to the Western mind, risk there is relatively low and a known quantity. Singapore and Hong Kong are similarly transparent. Japan is also evolving into this category, its fast-maturing market offering much lower risk than it did in the late 1990s: “the situation after 2000 is that there’s a high degree of liquidity in the market, a much greater degree of transparency, and a much lower perceived risk.”

At the other end of the scale come countries such as China, India, Indonesia, and Vietnam, which are usually perceived as the highest-risk destinations, a conclusion underlined by relatively high premiums for title risk insurance for investments in these destinations. The most common types of risk include the following:

■ **Title.** Property records in the Asia Pacific region can be inadequate or even forged. Even in more sophisticated markets such as Japan, land registration and land transfer systems are not entirely transparent. In less advanced markets such as China, bureaucracies can be corrupt, title documentation nonexistent, and authorities prone to both repossessing land they had earlier sold free and clear or rescinding/amending planning permission conditions. In India, records are patchy, the bureaucracy inefficient (and also suffocating), while title is sometimes clouded by religious customary rights and community property rules.

■ **Market Transparency.** Information about markets can be hard to come by. Market prices can also swing wildly with little notice. In less developed economies such as China, “available deals have hair on them,” meaning investors must devote lots of legwork to dealing with various bureaucratic, regulatory, and due diligence issues to sort the wheat from the chaff. This increases the time needed for deals to come to fruition. Legal rights and procedures are also opaque and judgments hard to

### Exhibit 1-7 Real Estate Firm Profitability Prospects



Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

enforce even if they can be obtained. Although conditions have improved in recent years, this exposes investors to greater risk of fraud or the excesses of corrupt officials.

■ **Government Regulations.** Government regulations may limit access to the market. Thailand, Malaysia, and Indonesia all have regulations restricting how foreigners can invest in local real estate. Korea has few direct restrictions, although one analyst commented that the current environment was “completely xenophobic, they don’t want foreigners in there,” adding that he saw the situation as temporary. In China, which over the last five years has become one of the most open markets in the Asia Pacific region for international property investors, the sheer volume of foreign money knocking on the door has made authorities increasingly nervous. In these circumstances, this is no surprise. As one interviewee observed: “If FDI is already running at \$60 billion, and that’s a record number, would you want another \$30 billion coming in on real estate?” Beijing is therefore making noises about restricting how foreign money can be invested in property deals, introducing draft rules in July 2006 that would tighten financing requirements and ban

foreign individuals and institutions from buying residential property other than for self-use. It is also trying to alter the development mix, limiting the number of lucrative high-end developments in favor of low-cost mass-market residential projects, an unpopular move among developers of all stripes who are understandably drawn to more profitable high-end schemes. Given Beijing's often limited ability to exercise control over business matters in the provinces, many believe the policy will be observed in the breach, illegal or not. Such a chaotic scenario would be typical of the property development environment in China, and illustrates the nature and extent of policy and regulatory risk in the country.

■ **Exit Problems.** Getting in is no good unless investors can exit investments easily. This is less an issue today than in the past. In most jurisdictions, interviewees say, repatriating profits is no problem. The main risk is in currency revaluations, which is commonly hedged. In China, although this can be problematic, “people are managing to do it.” India, though, has probably the tightest restrictions. By banning foreigners from making freestanding investments, it has effectively restricted them to entering the market as developers—an unattractive option because selling their development to other foreign players is problematic at best, thereby limiting their exit strategies.

The nature of the risk environment in the Asia Pacific region has a great bearing on which investors go where. China, for example, has drawn many investors who are willing to

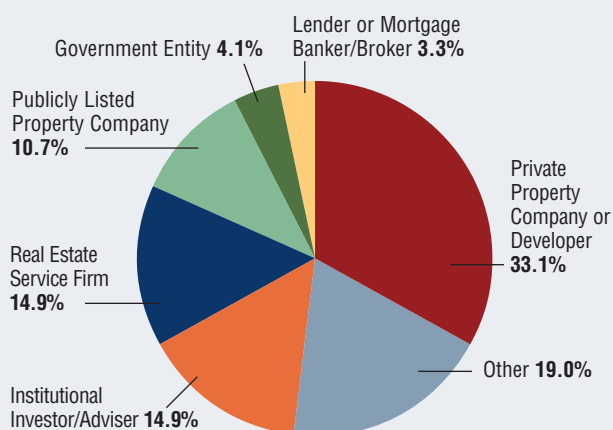
accept more risk in the expectation of higher returns. Risk-averse players such as pension funds tend to be drawn to the markets that are the most mature. These include the usual suspects, including Australia, Hong Kong, and Singapore, but Japan seems the most popular destination for this class of investor today. One obvious reason for this is its sheer size. Another reason is that the Japanese property sector has only recently reached a level of maturity sufficient to interest this class of investor. In the 1990s, the market had little liquidity and was regarded as opaque, an impression that began to change once the first JREIT listing appeared in 2001. The introduction of REITs in Japan not only provided foreign investors easy access and exit strategies, but it also vastly improved market transparency. The result, as one Japanese-based fund manager observed, is that “the constituency of investors has changed in Japan. There's now much more institutional money, while the vulture funds—the high-risk, high-return types—have moved to China.”

## The Future Looks Mostly Bright

Despite these many risks, the future looks mostly bright in 2007 for Asia Pacific real estate players of all types. Prospects for profitability are good for real estate firms generally, and these prospects are slightly better for 2007 than for 2006 (see Exhibit 1-7). Most interviewees expect the current extraordinarily high levels of real estate investment activity seen in the Asia Pacific region—and particularly in China—to persist throughout 2006 and 2007.

This is not, however, a foregone conclusion. Aside from significant economic risks (both in the Asia Pacific region and in the West), ongoing investor interest will depend on the ability of the Asia Pacific markets to deliver on investors' relatively high IRR expectations. And as yields continue to compress across the region, investor options are squeezed, too. Higher risk, combined with generally higher tax liabilities, leaves them little choice but to expect and command higher returns. In China, for example, expectations “for some groups have slipped to 17 to 18 percent net, but they can't slip much past that,” one consultant observed. “They need a big return in a high-risk environment.” That sentiment will resonate with investors across all other Asia Pacific markets, too.

**Exhibit 1-8** Survey Responses by Type of Firm



Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.





Real

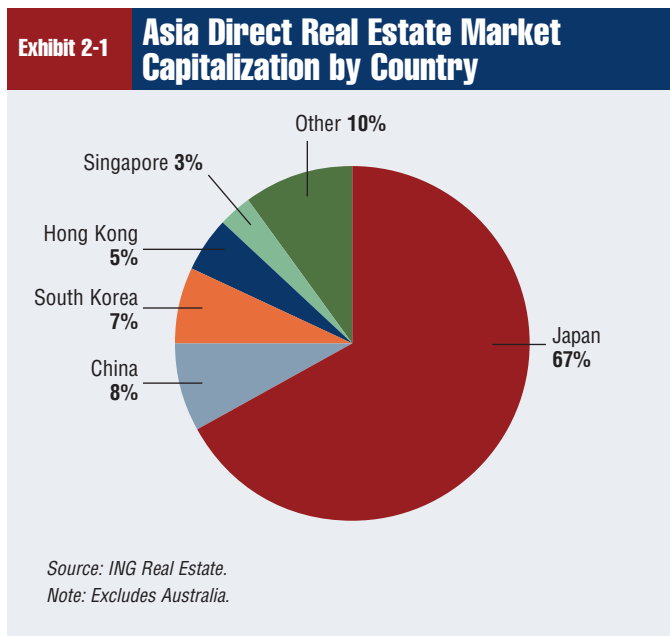


*“Asia Pacific real estate capital markets are expanding in scale and becoming more sophisticated, more diversified, and more securitized.”*

# Estate Capital Flows

Asia Pacific real estate capital markets are expanding in scale and becoming more sophisticated, more diversified, and more securitized. Pursuing higher returns, many investors are taking on higher risks. Over time, it is anticipated that as global investors become more familiar with the idea of investing in the Asia Pacific region, and gain in sophistication, early reticence will be overcome. As the quality and availability of information continue to improve, and as understanding of the various cultures and business environments in the region increases, cross border investors will make more informed assessments of investment opportunities, which will lead to broader, deeper, and more consistent capital flows.

As data on capital aggregates for the Asia Pacific region are sketchy at best at this time, insights into the relative market share of different sources of capital, by investor type and location, are more conceptual than precise, more directional—in terms of change—than explicit in quantitative terms. One estimate from ING Real Estate puts the total Asian direct real estate market capitalization at \$4.9 trillion, with 67 percent of this market capitalization located in Japan (see Exhibit 2-1),



8 percent in China, and 25 percent in the rest of Asia (excluding Australia). This ratio will be changing as China and other Asian markets grow rapidly, but for now there is a tremendous concentration of Asian real estate assets in Japan.

Much of this stock is not investment-grade property, and of the investable stock, most is still owner occupied. Notes a recent research report from RREEF Research, “Compared with North America and European countries, levels of owner occupation are relatively high, at around 80 percent of the investible stock. . . . In recent years, there have been a number of significant sale and leaseback transactions, particularly in Singapore and Japan, and this trend is likely to spread across the region in the medium term.”

Global capital is gravitating toward this sizable investment opportunity at an increasing pace. Responses to the *Emerging Trends* survey of Asia Pacific real estate industry leaders indicate that the availability of equity capital increased at a moderate rate in 2006 and is expected to continue increasing at a similar rate in 2007. Notes one investment manager, “The range and nature of private equity real estate vehicles being offered by international and local investment managers is increasing, which is providing investors with much greater choice. The importance of public equity real estate investment real estate vehicles is also increasing.”

Interestingly, survey results suggest that while availability from specific equity sources, such as private equity funds and REITs, will show a somewhat more modest increase in 2007 than in 2006, the availability of capital from all sources is projected to grow more strongly in 2007 than in 2006. This apparent inconsistency in survey respondents’ assessments may in part reflect that tracing the actual sources of capital generally can be a daunting proposition—and especially so in emerging markets, which are prevalent in the Asia Pacific property sector. The take-away message from this data pattern may be that survey respondents anticipate that new players, not readily classified by traditional categories, will be exerting increasing influence in Asian property markets.

Increases in the availability of debt capital have been less pronounced in 2006, and this pattern is expected to continue in 2007, with only small to moderate increases in both years. That said, there will be continued change and a growing international presence in this sector. Notes one investor, “We are seeing an increasing array of structured debt products and an increasing presence of global and regional lenders in cross-border environments.”

In the world of securitization, Asia Pacific capital markets are racing ahead. In terms of equity sources, after private equity investment funds and institutional investors, the publicly listed REIT and publicly listed property company sectors are expected to see the fastest growth in capital availability. Similarly, in the debt realm, the CMBS sector will see the strongest increases in availability. Both of these sectors are relatively small, but they are growing fast.

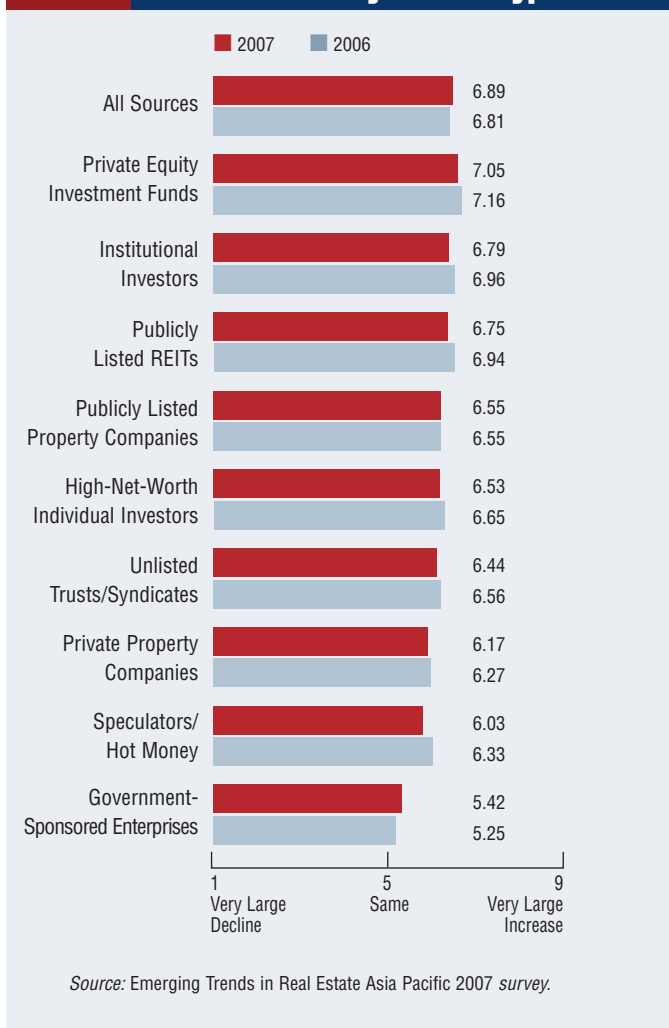
Advances in property institutions and services (e.g., legal, title, entitlement, etc.), particularly concerning issues such as verifying the validity of underlying property ownership, through title insurance, as well as perfecting the enforceability of certain mortgage instruments, will facilitate a more efficient and deeper capital market. As Asia Pacific markets increasingly offer attractive alternatives to the United States and Europe for investment capital, substantial capital will flow from those places to the Asia Pacific region. Moreover, expectations regarding Asian currencies compare favorably with other world currencies, especially against the U.S. dollar, and this will motivate investors to invest in Asia Pacific properties.

## **Growing Sophistication, Transparency, and Competition**

Growing sophistication and transparency and increasing competition for scarce available real estate assets are two themes that colored many of the comments heard from those surveyed and interviewed. As has occurred in the United States and Europe over the past dozen years, notes one observer, the Asia Pacific “real estate investment industry will experience greater securitization and real estate will increasingly behave like a financial asset.” Observes another, “We will see increasing liquidity, greater transparency, higher confidence from cross-border investors, and increased competition from cross-border funds. Our approach is to create more core assets to meet the rising demand.” Comments another, “It will turn much more competitive, and the current high levels of liquidity will probably continue for at least a year or two. Cap rates will continue to compress, but shrinking spreads may soon place a floor to this phenomenon.” Adds a U.S.-based investor, “The real estate investment and development industry will become more transparent with the entry of more institutional capital into the region. Both domestic and international firms will increase the sophistication of the investment process and it will become increasingly more competitive to execute deals.”



**Exhibit 2-2** Change in Availability of Equity Capital for Real Estate by Source Type



At the same time, the pure weight of capital flowing into Asia Pacific real estate puts returns, once they are adjusted for risk, under incredible pressure. An Australian observer says, “Weight of money will continue to drive yields down. Risk will not be adequately rewarded.” Another proclaims, “Competition has forced rates of return down from 20 to 25 percent to high teens.” There are some concerns about the ability of investors to completely realize their expectations if there are external shocks to the system.

## Equity Capital Plentiful

The greatest increase in the availability of equity capital in 2007 will continue to emanate from private equity investment funds, institutional investors, REITs and public property companies, and high-net-worth individual investors, in that order, according to the *Emerging Trends* survey. Each of these sectors will see moderate increases in the availability of capital in 2007, similar to the pattern seen in 2006 (see Exhibit 2-2). Sources that will grow more slowly include unlisted trusts/syndicates, private property companies, speculators/hot money, and government-sponsored enterprises. Notably, all eight of the capital sources surveyed, save government-sponsored enterprises, are expected to see small to moderate increases in capital availability in 2007.

Interestingly, the most significant shifts in direction are expected to come from government-sponsored enterprises, where increases in availability for 2007 will exceed those seen in 2006 (most private sources are expected to see slower growth in availability), and from speculators/hot money, where significant slowing in the rate of growth is expected as the market matures.

Growing sophistication will lead to numerous changes, including new products and changing return expectations. Notes one investor, “The large flow of capital into the Asia Pacific real estate markets is being met by a launch of many new products, private funds, and publicly listed vehicles [REITs and REOC IPOs]. As capital becomes more familiar with the region, return expectations will moderate and more capital will get placed into the market. Transaction volumes are likely to increase in the next two years as a result.” Notes another observer, “Capital availability will increase over the next 12 months as REITs become more active. I also see smaller investors finding vehicles, which will allow them to invest in formerly ‘nonretail-sized’ deals.”

On the spectrum of investing in core, value added, or opportunity, many respondents noted that core is very hard to invest in, and that the latter two categories offer more and better options. There simply are not enough high-quality assets available for sale in the market for core investors. One observer describes the difficulty of placing capita as follows: “Depends on appetite for risk; core—very hard; value added—lots of opportunities.”

There will continue to be plenty of competition when core assets become available. Notes one observer, “I see more investors getting into real estate via the public securities side because it is tactically easier than implementing a hard-asset strategic plan. That said, the focus of the larger investors remains on direct investment.”

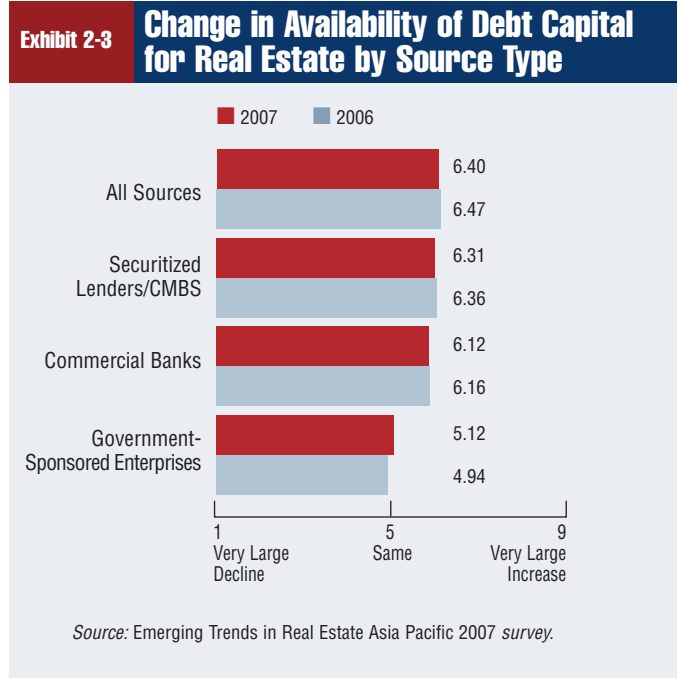
## Debt Capital Sector Evolving

Debt capital markets in the Asia Pacific region are relatively immature and still reliant upon banks. Notes one international observer, “Debt capital is primarily supplied by commercial banks. Securitized debt markets are very immature, with the exception of Japan; the securitized debt sector will take some time to gain traction.”

As noted above, survey respondents expect debt capital availability to grow in 2007, but not quite as strongly as in 2006 nor as strongly as the growth in equity capital. Survey respondents expect that the availability of debt capital will increase in the small to moderate range in 2007, slightly less than in the prior year (see Exhibit 2-3). Indicative of the growing influence of securitization, the greatest increase in the availability of debt finance is projected to emanate from securitized lenders/CMBS. Commercial banks are expected to show a small increase as are government-sponsored enterprises; availability from the latter will actually improve in 2007 over 2006, whereas growth rates for other debt sources will be down a bit.

While debt instruments, especially those involving securitized financing arrangements, are less advanced in the Asia Pacific region than in the United States and Europe, sophistication levels are changing. Various respondents point out that mortgage securitization will likely be growing substantially, with government support being a crucial factor influencing such growth.

As a practical matter, while the vast majority of real estate leaders surveyed were active in the equity markets in the Asia Pacific region, only a minority of them participated in the debt side of the market generally, with participants in securitized financing being an even more limited group. Respondents expressed the expectation that in the coming years there will be increasing involvement in debt generally and mortgage securitization particularly. While the mezzanine market is thin at present and a robust CMBS market is some years way, survey respondents anticipate that over time these markets will expand



and become more of a factor. Notes one Hong Kong-based investor, “Mezzanine lending platforms are starting to develop; capital is coming from offshore as well as local investors.” Some, in answering the survey, said that government efforts to deal with problem loans, especially in China, could stimulate expansion of the securitized debt markets.

One of the implications of the growth of property securitization is that much of the new capital comes from nonbanking private sources, investing in the securitized vehicles. Moreover, as securitization expands, the character of lending will change, with recourse and relationship orientation diminishing. Further, securitization will bring standardization of documents and loan terms, moving to international standards beyond local stylistic provisions, which will make nonrecourse lending more broadly available.

## Diverse Array of Domestic and Cross-Border Capital

Asia Pacific real estate investment capital is being generated from three general sources: domestic capital generated from within a country and invested in that country, capital migrating from one Asia Pacific country to another, and capital being invested in the Asia Pacific region from outside the region—

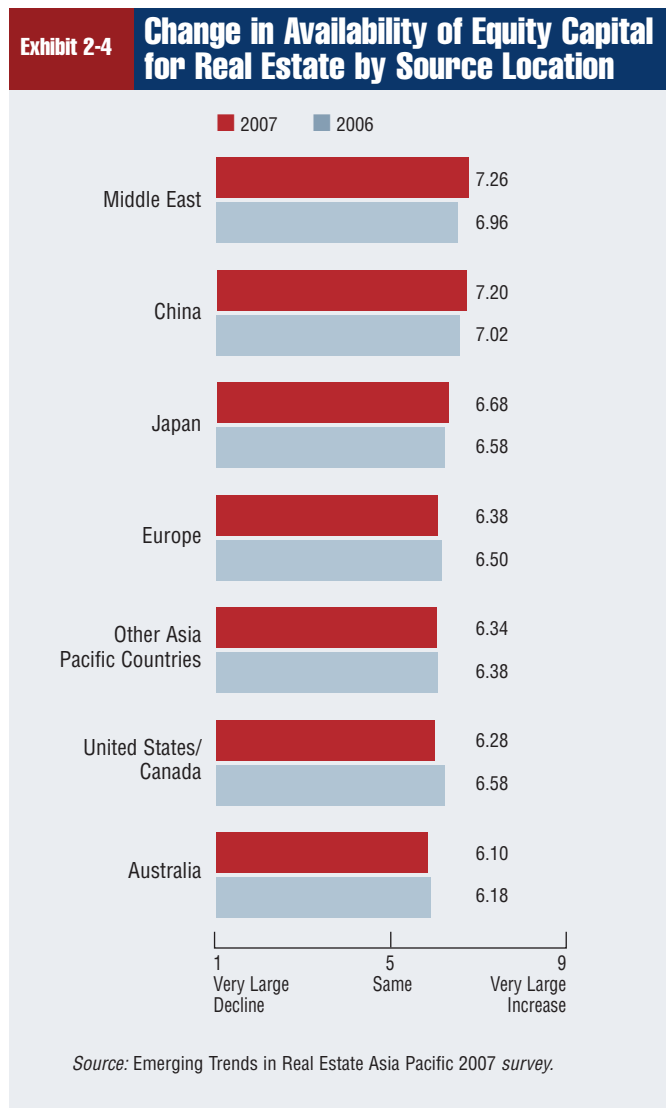
e.g., the Middle East, Europe, the United States. Much real estate investment has been and will continue to be of the first variety, but the latter two sources are the big story and are growing rapidly. The migration of capital from one country to another is being driven by a variety of factors:

- A favorable comparative assessment of opportunities in another country vs. the home country;
- Motivations to gain exposure to investments, whose outcomes are influenced by different economic forces and to spread risks;
- Improving cultural comfort and attitudes toward investing in other places generally;
- Improving legal systems and regulations governing real estate and capital flows;
- Improving transparency and quality of property institutions, information research, investment vehicles, and managers;
- Marketplace improvements that have created greater tax neutrality and easier repatriation of capital.

The largest increases in the availability of real estate capital targeted for the Asia Pacific region are expected from the Middle East, China, and Japan, where moderate growth in availability is expected and this growth is expected to exceed that seen in 2006. Smaller increases are expected from Europe, other Asia Pacific countries, the United States/Canada, and Australia, and all of these sources are projected to see lower rates of increase in 2007 than were seen in 2006, especially from the United States/Canada (see Exhibit 2-4).

While the flow of international capital into the region is capturing much of the attention, internal growth of capital within the region is substantial and a major story in itself, and at least one observer believes this will lead to significant shifts: “Domestic capital will replace foreign capital as the chief funding source of large-scale investment activity.” Notes another, “More players both global and local, especially the latter. More investors from the Middle East and within Asia.” Another notes, “Growing prosperity within many Asia Pacific countries means that more and more investable funds are being generated within these countries. These investable funds are being invested both in the home country, where they are generated, and selectively in other countries as well.”

The expanding role of securitization of Asia Pacific real estate will likely increase cross-border capital flows and increase the accessibility of such property interests to investors from different countries; this trend will offer opportunities for local



equity holders to sell their property to both regional and international investors. Securitization will lead to a realignment of ownership relationships, so greater proportions of property will be owned by investors not resident in the country where the property is located.

The source of capital often influences risk perception and therefore return expectations. Investors who are investing in their home country often see less risk, or perceive risk differently, than those investors who are crossing borders to deploy



“We’ll see more foreign investors take **development risk.**”

their capital in another country. And, investors who are sending their capital into a region from outside the region often perceive higher risk and therefore expect higher returns. Thus, as domestic capital sources increase in size, especially in emerging markets, they will become even more formidable competitors for the larger and more complex real estate investment opportunities.

## Investing in Development

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Because there is generally more capital chasing properties than there are good properties to buy, many investors are increasingly looking to development as a way to invest their capital. There is a tremendous amount of development underway throughout the Asia Pacific, especially in China, and there will be more on the way so long as the high levels of economic growth continue in the region. Development prospects rated higher than investment prospects in ten of the 19 cities in the *Emerging Trends* survey.

The “invest in development” theme was mentioned frequently in the surveys and the interviews, and from a range of observers in various locations. Tokyo: “We’ll see more foreign investors take development risk.” Singapore: “Development will provide the greatest returns and opportunities at reasonable risk.” And, “It will be increasingly difficult to secure good existing assets, and hence, the need to ride the development cycle. However, that development space will also turn competitive because many investors will hold the same view if they don’t already do so now.” Shanghai: “Investment-grade assets in China are difficult to source with irrational vendors and inexperienced buyers. The best opportunities remain in development.” Hong Kong: “There is a scarcity of good stock, so there will be more funding of development pipelines.” Further, “With lack of supply in the ready-built market and compressing yields, more funds are being driven into the development sector, where more realistic risk/reward ratios are available.” United States: “There are relatively few opportunities for acquisitions of existing assets; however, we see significant growth and opportunity in ground-up development.”

Investing in development can also ensure that the investor acquires a good-quality, functional, and modern facility, which is sometimes in short supply in emerging markets. Notes one observer, “The development industry in Asia will become more attuned to the requirements of multinational corporate occu-

piers and respond with higher-quality, better-planned, and better-managed product. This will be driven by the wave of institutional investment, both directly into real estate and into real estate development companies.”

Capital flows to development will take many forms and come from many sources. A Korean observes, “For the real estate development industry, more financial institutions will participate in development projects as limited partners.” Explains a Malaysian consultant, “The markets are all becoming more sophisticated and we will see publicly listed trust funds more active in south-east Asia looking for quality investments. This will improve the attitude to development and move it from family-run developers and their personal preferences to market-driven development. The downside is less intuitive creativity and more homogeneity.”

Investors are looking to invest in value-added and redevelopment schemes as well. A New York-based investor states, “Our five-year plan is to focus on development and repositioning opportunities and be diversified.” A London-based investor adds, “We see more opportunities in the residential sector, where there is particularly room for development, especially for value-added and opportunistic funds.”

However, overbuilding is certainly a risk in some markets. One Hong Kong observer says, “Governments are becoming concerned about increases to supply and are trying to find ways to limit or at least control new construction.” But overbuilding threatens all real estate investors, not just developers, and thus many investors will continue to pursue development as a better risk-adjusted investment opportunity.

## REITs and Securitization Outlook Bright

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As noted earlier, perhaps the most pronounced Asia Pacific real estate capital market trend is growing securitization, which has taken several forms:

- More public equity securitization, including listed companies, REITs, and equivalent REIT-like vehicles.
- More commercial mortgage-backed securities (CMBS).
- More initial public offerings (IPOs) of real estate companies.

In discussing the outlook for annual growth in the volume of property securitization, one Asia Pacific real estate market leader observed, “Short-term growth will be around 20 percent

and in the long term it will settle down around 12 to 15 percent.” Notes another, “There will be huge growth in the next year due to increasing structured regulations and laws permitting the same.”

With securitization accounting for a growing market share of the real estate capital market, developers and entrepreneurs who previously might have done private joint ventures will be faced with several options: continue as before with private deals; sell properties to securitized vehicles; convert the enterprise into a real estate investment trust or listed public company; or for more development-oriented enterprises, pursue an initial public offering to become a public real estate operating company.

A further benefit of the listed company or REIT structure is that entrepreneurs, developers, and promoters can get access to capital for ventures that they would not customarily be able to access readily. Thus, the REIT structure, for example, can readily accommodate floating the shares of entities that would focus on nontraditional properties. Further, as one savvy market observer offered, “Anything that has a cash flow and a P&L can be potentially reached.” The expectation is that, just as the REIT structure has been extended to nontraditional properties in the United States, so too is it likely that nontraditional assets will be included in REIT portfolios in the Asia Pacific region in the future, especially in Japan, where the REIT structure is more mature.

It should be kept in mind, however, that there is no single REIT market in the Asia Pacific region. Notes one observer, “Hong Kong and Singapore are battling to be the regional hub for REITs; expect a surge in IPOs. Japan has a growing REIT market, with lots of IPOs in line; expect to see specialized product REITs as the next step. Korea legislation is not suitable to fostering growth of the business model. India and China may take some time to gain traction as they have poorly developed equity capital markets.” Notes another, “Hong Kong REITs with China-based assets are of interest to investors as a way to play that market.”

While some respondents noted that there are regulatory obstacles to the expansion of REITs, they note that there is strong momentum and push in the region to provide a regulatory framework that will enable entities that are not private to operate in a manner functionally equivalent to public REITs. As countries other than Australia and Japan account for a relatively small percentage of the total REIT market capitalization in the Asia Pacific, substantial REIT growth can be anticipated.

As the liquidity, transparency, and tax-neutrality features of global real estate securities are very attractive to individual and institutional investors worldwide, there will be growing demand for these securities and a growing number of initial public offerings in the coming years. As the role of public real estate securities expands, various entrepreneurs and related public companies are positioning their portfolios for future REIT offerings. This growth pace is reflected by the surge of new REIT offerings in Asia in 2005.

While there is a positive future outlook, some observe that the markets do not seem to have learned that much from experience in the United States and Australia. In particular, the recent practice of employing financial engineering techniques to support dividends expectations—basically using proceeds of the offering to pay a level of current dividend returns to investors above that which is generated by the property portfolio—is cited as a potential problem.

Property securitization is expected to grow dramatically in China, given the extraordinary number of properties that could be appropriate for property securitization that are being developed. Given the scale of the major projects in China, one REIT vehicle may comprise just a single major development of multiple hundreds of millions of dollars in scale. The REITs that originate in other places, such as Korea and Japan, by contrast, might consist of a more diverse portfolio, perhaps ten to 20 different properties. Another force driving growth in property securitization is government desires to privatize their property investments in the near future.

The property securitization structure is perceived to be especially appropriate for Asia, insofar as it would promote better governance, transparency, and discipline. The basic structure of the REIT can provide investors some confidence and comfort, beyond what might apply in a private direct equity transaction. Moreover, the quarterly reporting requirement promotes transparency, and the visibility resulting from coverage by investment analysts imposes a discipline that would not otherwise apply.

The combination of the market’s demand for capital—and higher returns that can potentially be realized on real estate ventures in the Asia Pacific region—also will drive strong increases in real estate securitization. Property securitization in much of the Asia Pacific region is in its infancy and will grow substan-

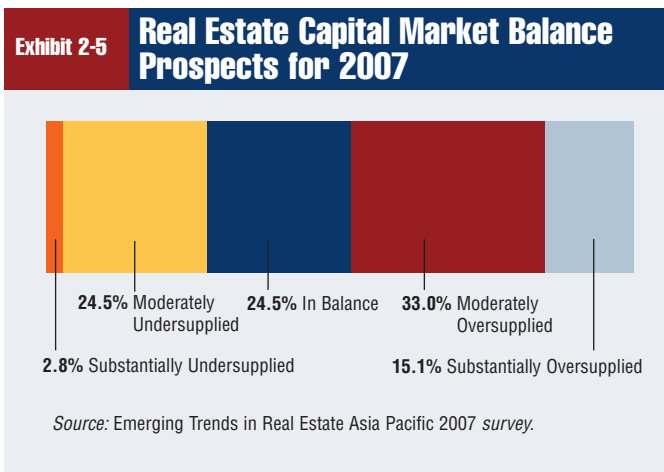
tially. One respondent observed that public real estate securities markets are “still going gangbusters with more initial public offerings. Investors flock from IPO to IPO, speculating on the next big winner—sort of a speculative gaming mentality applied to real estate securities investing.”

In addition, many property developers will be motivated to go public because the dual forces of substantial growth and the prospects of much larger projects mandate much larger aggregates of capital. Recognizing that public securities provide more comfort to prospective investors, more and more major developers, especially in China, will likely be pursuing listing their shares on the public market.

## Is Capital Disciplined? Are Flows Sustainable?

Real estate industry leaders in the Asia Pacific region were somewhat mixed in their assessment concerning the degree to which capital is disciplined. There was less consensus among respondents about the relative degree of disciplined capital than certain other topics. Some insisted there is little or no discipline, essentially implying that there is an anything-goes spirit. Warns one observer in Japan, “I am concerned about the recent wave of private equity hedge funds that may be getting in over their heads; there is sufficient ‘smart’ money on the sidelines to take them out—at a price—if they get into trouble.”

A comparable number of respondents were on the other side of the discipline equation, asserting that there was strong discipline. One Hong Kong-based observer proclaims, “Discipline is much better than ten years ago; still see some ‘oddball’ deals getting done, but most investors are fairly ‘level headed’ about it.” Others espoused a more nuanced point of view, observing that more discipline is applied to debt than to equity.



Whatever the level of discipline, there is strong consensus among Asia Pacific investors that strong continuing interest will ensure the sustainability of current high levels of capital flows into the real estate market. Notes one Japan-based observer, “Capital flows are sustainable, and are not based on hot money. The Asia Pacific region had lots of liquidity before interregional capital flows became an issue. We will not see a bubble bursting, but we may see capital moving to other relative value opportunities.”

This is supported by *Emerging Trends* survey data, which suggest that capital for real estate investment will be in ample supply in 2007 and for the foreseeable future. Some 48 percent suggested that the market will be moderately or substantially oversupplied, while only 27 percent felt the market would be moderately or substantially undersupplied; the remaining 25 percent felt the market would be in balance (see Exhibit 2-5). Of the approximate one-sixth of respondents who believe that the supply of capital substantially diverges from a balanced situation, nearly six times as many (15.1 percent) think that capital is substantially oversupplied than substantially undersupplied (2.8 percent).

Because higher levels of economic growth are anticipated in the Asia Pacific region than in Europe and the United States, businesses operating in Asia Pacific markets prospectively will be generating greater revenue growth, higher levels of prof-



itability, and therefore stronger investment returns. Indeed, this very economic prosperity is what creates demand for property goods and services in the Asia Pacific region. The sustainability of high levels of capital flows into the real estate market in the region, then, is anchored less in the expectation of the comparative advantage of real estate returns over corporate returns, than on the fundamental growth potential of the region. Many people, both within the region but especially those outside of it, recognize that investing in property goods and services is an excellent way to participate in a place's economic growth, expansion, and prosperity.

Offsetting the consideration of the probable continuing appeal of the real estate asset class is the consideration of how a shock to the system might affect investors' continuing confidence and interest. But, as a survey respondent points out, the shock to the system that would be adverse to real estate would concurrently affect all asset classes, and recent experience shows that real estate has weathered such shocks as well as and perhaps even better than other asset classes.

Various respondents observe that while markets certainly have run up recently, there is no real evidence of an imminent price crash. Indeed, some of the price escalations reflect more cyclical upswings from lower prior phases than unjustified appreciation. And, while there is some talk of high price levels in certain residential markets, as a case in point, income gains in those markets have more than matched housing price growth. Overall, respondents perceive that current levels of capital flows into real estate are fairly stable, and they do not see a market bubble.

However, industry players are concerned about a few key issues that they think might restrict future growth and profitability. A number of respondents believe that a hike in interest rates along with a generic downturn in economic growth in major economies—like the United States, Japan, and China—could be a source of potential threat to returns. In addition, uncertainties regarding changes in government leadership across a few countries, and subsequent ambiguity regarding policy directions, ranging from development policy to foreign policy, will raise some clouds of uncertainty.

Poor market transparency and the lack of reliable information on real estate, including the absence of appropriate financial benchmarking, have also been considered deterrents. One respondent pointed out the need for greater consistency in operations and reporting from new managers in the real estate management realm. The dearth of skilled and experienced professionals to meet the needs of the industry in the short run was also highlighted. Other factors that were of concern are increasing vacancy rates for luxury houses in Japan, cases of poor planning of projects in China, and high entry barriers for small developers due to a lack of experience and hence low credibility. Another concern was central bank policy: "Watch central banks' actions—they could [affect] availability of capital."

But overall, these are not major concerns and they are not holding investors back. The Asia Pacific region will be growing and developing faster than any other area of the world for many years to come, and over the long term that can only be good for real estate investors. They know this, and they will increasingly be moving capital toward Asia Pacific real estate opportunities.

A low-angle, upward-looking photograph of several modern skyscrapers. The buildings are framed by a dark, curved architectural element on the left. A bright sun flare is visible in the center of the sky, partially obscured by the buildings. The overall color palette is dominated by dark blues and greys, with a warm, golden glow from the sun.

# Markets to

*“This is the **place** to be.”*

# and Sectors Watch

Eventually, capital needs a three-dimensional, physical place to grow. The enormous property capital flows and funds directed toward, and active in, the Asia Pacific region ultimately reach and secure a property in a specific city, or potentially many cities, with portfolio investments. It is at the city level that Asia Pacific property markets show their true dichotomous character—on one hand, there is the complex and unique nature of each property market’s economics of supply, demand, and pricing, and what drives property demand—is it domestic job growth and rising income levels, or is it also fueled by foreign investment and multinational firms entering the market? On the other hand, there is the enticing nature of a growing economic and demographic force in the global economy for many Asia Pacific cities, very prominent in the media and industry press, thus attracting prospective international and regional real estate investors. “This is the place to be,” claims an international consultant.

However, in spite of the complexity and enticing nature of Asia Pacific real estate, interviewees still mention significant differences in “. . . the range of maturity across the Asian property markets” or describe them as “. . . sometimes chaotic by Western standards.” Based on our interviews, property market maturity is a key theme in 2006 and for 2007, and encompasses more than domestic real estate capital markets; market maturity also refers to factors such as transparency, political risks, institutional development, and openness to foreign real estate investors. If the REIT model continues to expand in the region and capital markets continue to mature in the Asia Pacific region, then the public disclosure of real estate performance and information of properties, firms, and Asian cities will naturally increase. Increasing the knowledge base of Asia Pacific real estate markets is one step toward market maturity.

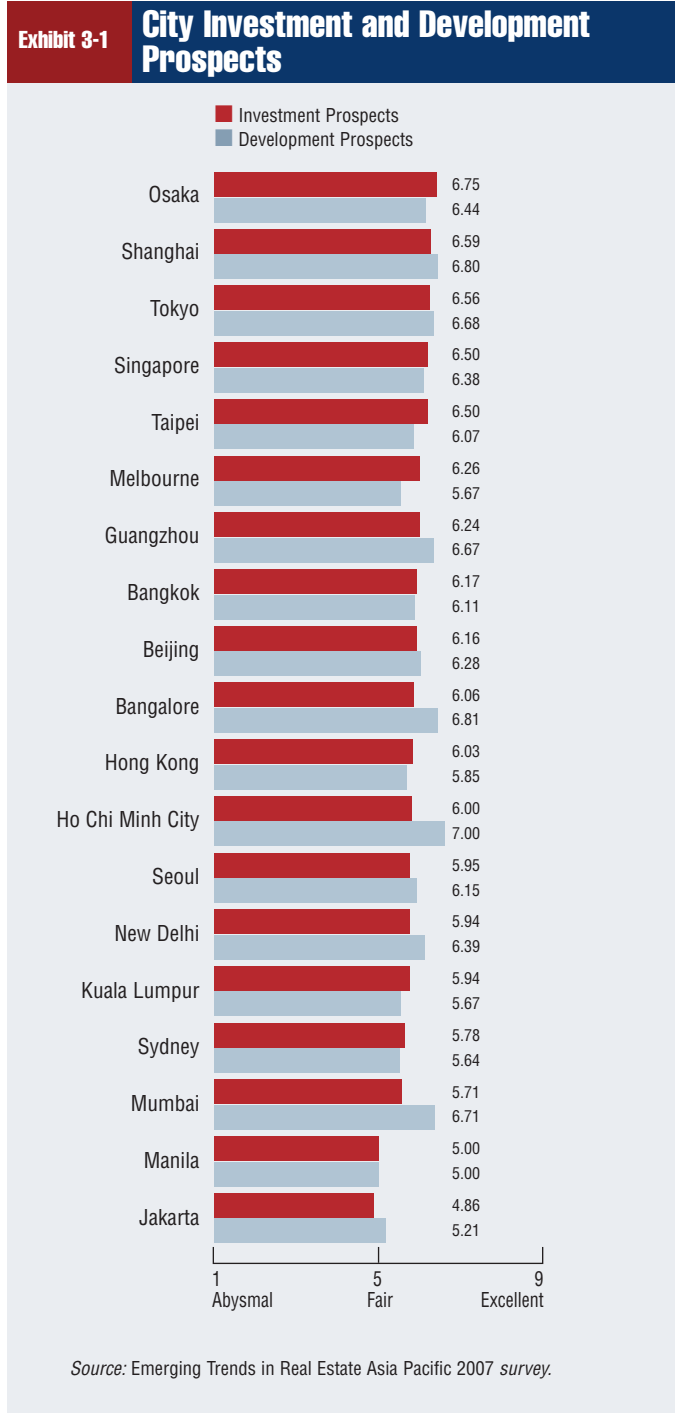


Over time, the growing importance of global real estate capital flows, investments, and cross-border transactions will change the way foreign and domestic investors participate in the Asia Pacific region and cities. The evolutionary path of individual Asia Pacific real estate markets will influence who is active in a particular city and who isn't. If transparency in a particular city is low, then domestic investors—those with local market knowledge—will dominate due to their advantages over foreign investors. As more foreign and domestic investors learn about the intricacies of investing in Asia Pacific cities, there will be a “raising of the bar” of real estate information, research, and human capital, thus benefiting existing and future Asia Pacific shareholders. As one survey respondent stated, “. . . domestic and international firms will increase the sophistication of the investment process and it will become increasingly more competitive to execute deals” in the Asia Pacific region. Developing a full spectrum of public and private, equity and debt real estate capital markets that encompass all Asia Pacific cities is another step toward market maturity.

So, which cities do our interviewees and survey respondents believe offer the best opportunities for investment and development? And how diverse do our survey respondents believe are the opportunities to buy, hold, and sell office, retail, industrial/distribution, apartment residential, and hotel/resort properties? Where to go in such a diverse region in the world?

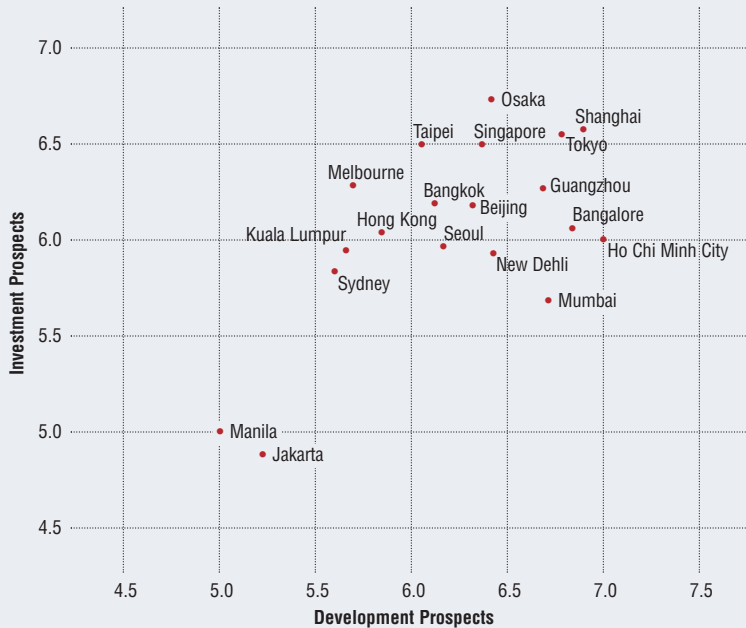
## A Diverse Group of Cities and Opportunities

Ranking cities is an art and a science. It provides local government and economic development agencies relative benchmarks to compare their cities against others, and for private firms to evaluate current and future investment strategies and allocation of management resources. When rating cities, it must be kept in mind that the attractiveness of any given location depends greatly on an investor's risk profile. It is very hard to compare investments in, say, Osaka, with those in, say, Chengdu. Osaka will yield maybe 4 to 5 percent; Chengdu will yield potentially much higher. Both cities may be ideal locations for the right players, but those players will almost certainly have completely different priorities.



Survey respondents rated 19 Asia Pacific cities on investment and development, and also on whether it was a good time to buy, hold, or sell office, retail, industrial/distribution, apartment residential, and hotel/resort properties for each city. Exhibit 3-1

**Exhibit 3-2 Investment vs. Development Prospects**

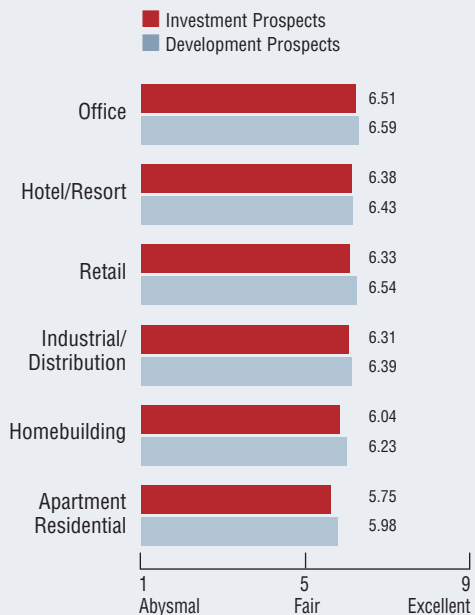


Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.  
Note: 5=fair, 6=modestly good, 7=good.

provides the average weighting of investment and development prospects ratings for our roster of 19 Asia Pacific cities. The exhibit ranks cities by investment prospects similar to the methodology used in *Emerging Trends Europe* and *Emerging Trends U.S.* A higher rating indicates better investment or development opportunities, as scores ranged from a low of 1 to a high of 9. Osaka, Shanghai, Tokyo, Singapore, and Taipei rank as the top five investment prospects cities.

High investment prospect ratings do not necessarily translate into high development prospect ratings; ten cities have a higher development rating than their investment rating. Exhibit 3-2 is a scattergraph illustrating the relationship between the two ratings; the development rating is on the X axis and the investment rating is on the Y axis. Although Ho Chi Minh City rates highest for development prospects, the city's investment prospectus is average compared with that of other Asia Pacific cities. The differences between the investment and development ratings offer strategic clues for domestic and foreign real

**Exhibit 3-3 Real Estate Sector Performance Prospects for 2007**



Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

estate firms. For example, Vietnamese securities markets are relatively immature and, according to the Land Administration Agency, domestic commercial banks are tapped out as a source for real estate loans. Thus, there is potentially an increasing role for foreign investors in Vietnam to meet growing development demands rather than investment in the country as evidenced by the oversubscription of a recent fund offering.

## Property Sectors in Perspective

In addition to rating cities on investment and development prospects, survey respondents rated property sectors. Exhibit 3-3 highlights the general outlooks for investment and development for the Asia Pacific region. Office and hotel/resort rank first and second respectively, which supports the economic development

**Exhibit 3-4 Asia Pacific Office Vacancies**

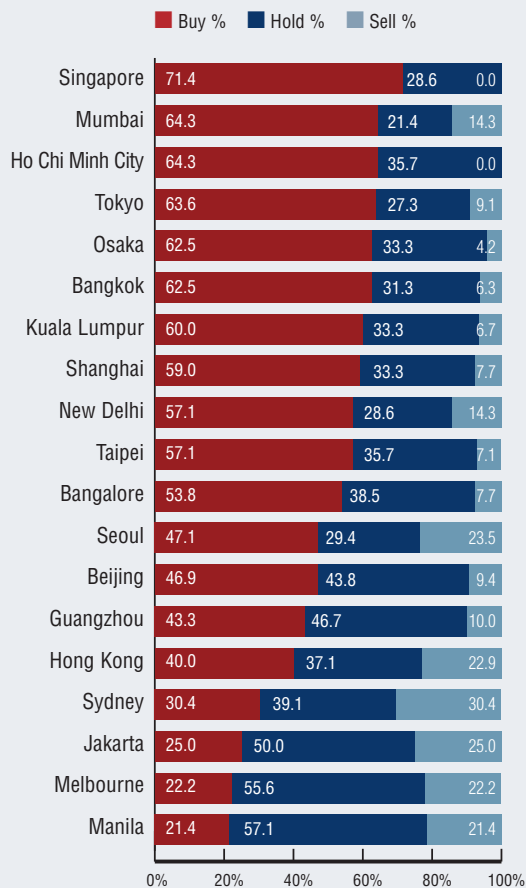
Mumbai CBD	3.00%
Seoul CBD	3.10%
Hong Kong Central	3.20%
Tokyo CBD	5.40%
Shanghai (Central Puxi)	6.80%
Singapore CBD	7.50%
Makati CBD (Manila)	8.10%
Melbourne CBD	10.40%
Sydney CBD	11.20%
Bangkok CBD	14.20%
Taipei CBD	15.20%
Beijing	15.30%
Kuala Lumpur CBD & GT	16.10%
Jakarta CBD	18.50%

Source: Jones Lang LaSalle Research, Second-Quarter 2006.

evolution of the Asia Pacific region. Increasing growth in financial and professional business services supplements existing stable economic growth drivers in the manufacturing sector. The increase in tourism and business travel within and to the Asia Pacific region inspires optimism among real estate investors and developers for the hotel/resort sector. Retail and industrial/distribution closely follow the office and hotel/resort sectors. It is a bit unusual in a region with such growth in urbanization and rising income levels that homebuilding and apartment rate the lowest of the property sectors.

Survey respondents also rated each city for buy, hold, and sell opportunities for office, retail, industrial/distribution, apartment residential, and hotel/resort property types. The buy, hold, and sell distributions by property type illuminate significant differences across the Asia Pacific cities. Similar to the other *Emerging Trends* regional publications, cities are ranked based on the buy percentages, from highest percentage to lowest percentage. The method of ranking cities influences how cities compare with one another. An investor may be interested in which markets offer the best prospects to buy a specific property type, whereas another may be interested in which markets are best to sell properties. On average, office and hotel/resort properties ranked highest for buy opportunities, with retail, industrial/distribution, and apartment residential highest to hold. “Everyone likes office,” declares one interviewee.

**Exhibit 3-5 Office Property Buy/Hold/Sell Recommendations by City**



Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

**Office Sector.** High investor ratings for the office sector reflect investor preference for offices, but not necessarily the availability of investable office stock. In fact, in China and often elsewhere, the reality is that there is minimal opportunity to invest in prime, fully let office projects in major markets, pushing investors into secondary markets.

There are also significant differences among the 19 cities. Office vacancies, for example, range from a low of 3 percent in Mumbai to 18.5 percent in Jakarta. Moreover, there is a clear segmentation for cities with at least 50 percent office buy ratings versus cities with less than 50 percent office buy ratings, as illustrated in Exhibit 3-5, which shows the distributions of buy, hold, and sell for office for the 19 cities. Singapore, Mumbai, Ho Chi Minh City, Tokyo, and Osaka rank in the top five

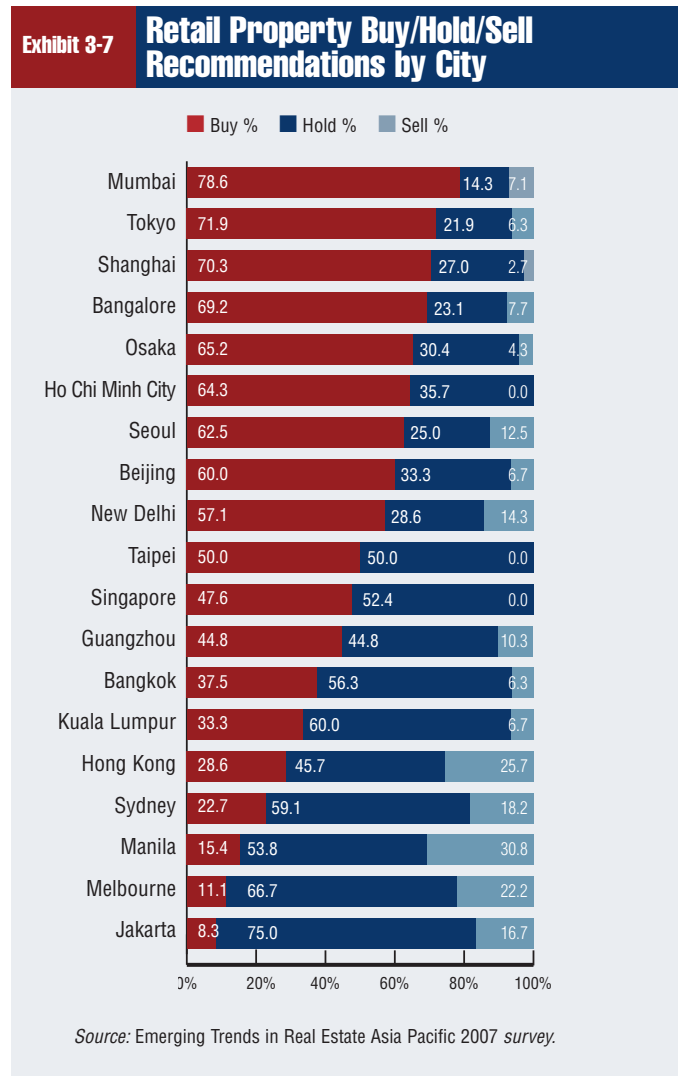
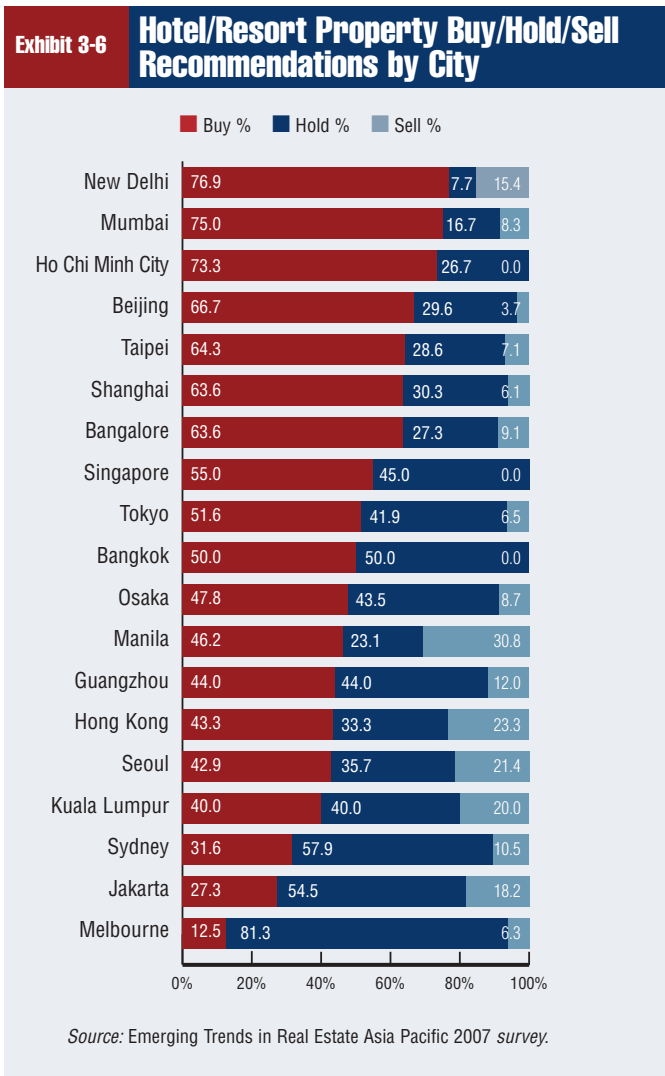


office buy ratings, whereas the high office hold ratings for Manila, Melbourne, Jakarta, Sydney, and Hong Kong effectively rank them lowest in the buy category. The imbalance between respondents' buy and sell ratings is clearly shown in Singapore and Ho Chi Minh City; how do investors buy if no one wants to sell? In contrast, the lowest five buy rated cities have a balance between buy and sell proportions, thus increasing the likelihood of an active investment market.

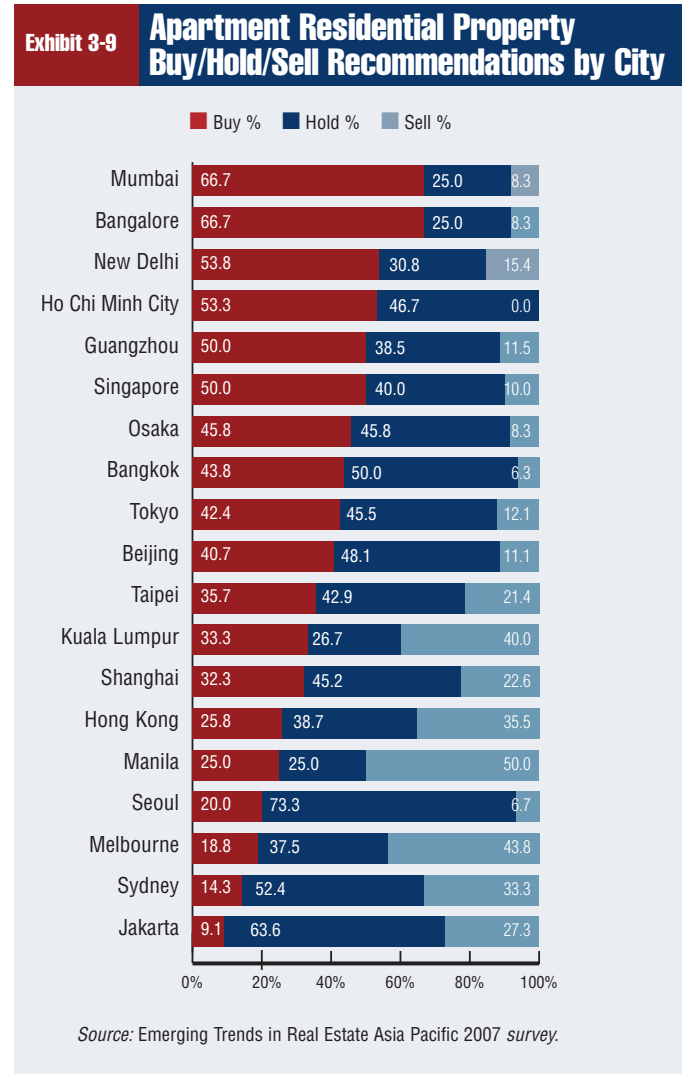
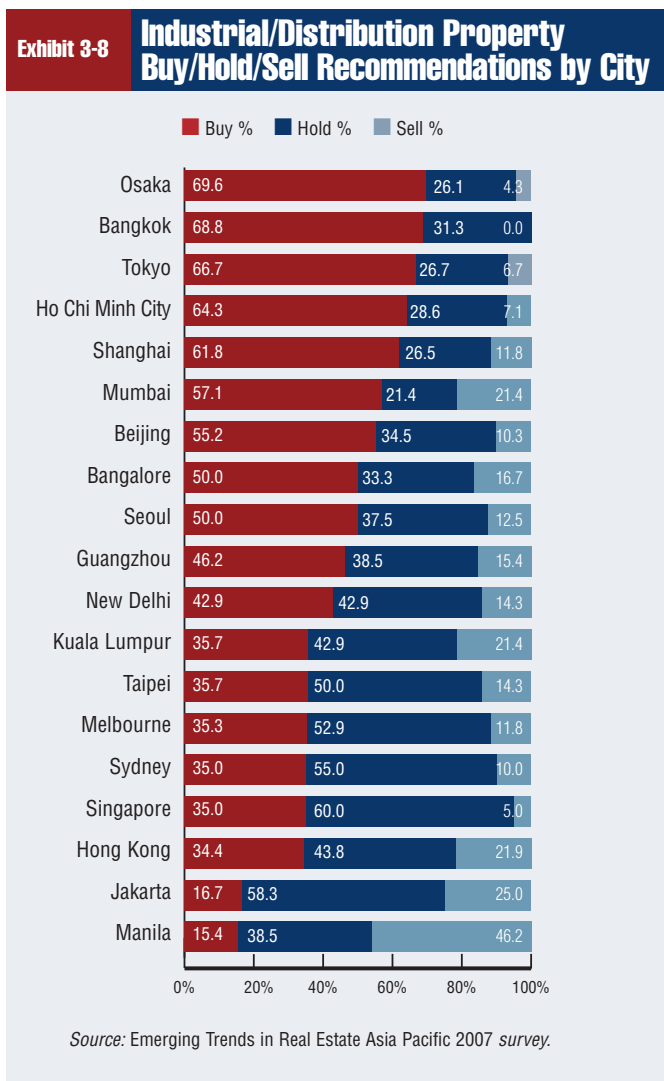
**Hotel/Resort Sector.** The hotel/resort distributions show a step-down pattern when ranked by the buy percentage (see Exhibit 3-6). New Delhi, Mumbai, and Ho Chi Minh City form the top step, followed by Beijing, Taipei, Shanghai, and Bangalore on the next step, and then gradually sliding down to

Melbourne's low buy percentage primarily due to a large hold signal. Manila received a fairly high sell signal for this sector. "Hotels are doing relatively well," according to an international adviser, while another interviewee expresses that hotels "may well be the catalyst for growth in mixed-use entertainment, housing, and retail" in the future. Several interviewees mentioned the need for increasing mixed-use developments in several of the highly dense urban cities.

**Retail Sector.** The retail sector ranks third for investment (modestly good prospects) and second for development (good prospects) in the *Emerging Trends* survey. Retail goods are in demand by a growing middle class in many emerging Asia Pacific markets, especially China and India, and modern retail



facilities are still undersupplied. “Retail and logistics are big niche markets,” according to an Asian real estate investment consultant. For retail, there is a gentle linear reduction of buy rating percentages from top to bottom as shown in Exhibit 3-7, unlike other property types that typically have stepwise changes in buy distributions, such as the office and industrial/distribution properties. Mumbai, Tokyo, Shanghai, Bangalore, and Osaka rank in the top five retail buy category, with strong hold signals for Jakarta, Melbourne, Manila, and Sydney.



Manila and Hong Kong received the highest sell signals, potentially indicating that our respondents believe that these two markets have either peaked, as in the case of Hong Kong, or declined, as in Manila.

**Industrial/Distribution Sector.** Industrial/distribution buy indicators, shown in Exhibit 3-8, are strongest in Osaka, Bangkok, Tokyo, Ho Chi Minh City, and Shanghai, then gradually descend to New Delhi before stepping down to the cluster of cities from Kuala Lumpur to Hong Kong. Manila’s 46 percent sell distribution for industrial is one of the largest sell signals for all cities and property types, followed only by a 50 percent sell distribution for Manila’s apartment residential market

**Exhibit 3-10** Leading Asia Pacific Cities



Several interviewees mentioned that seniors' housing and second-home markets "... look interesting," although such property types may require considerable consumer education and cultural adaptations before gaining a foothold in the Asia Pacific region.

**Diversity and Unity.** Diversity of opportunities and expectations in the Asia Pacific cities are clearly illustrated with the city rankings, the investment and development scattergraph, and property buy, hold, and sell distribution exhibits. There is strong competition to simply "do deals" in most of the Asia Pacific cities. Because of the competitive nature of investing and owning real estate in the major Asia Pacific cities, our survey respondents also indicate strong possibilities of real estate capital movement to secondary cities or satellite cities near primary cities over the next few years in order to expand the universe of cities and investments. Cities that were mentioned in our survey include Shenzhen, Macau, Chongqing, Chengdu, Wuhan, Nanjing, Sicheng City, and Tianjin in China; Kuching and Kota Kinabalu in Malaysia; Nashik and Hyderabad in India; Phuket in Thailand; Nagoya in Japan; Auckland in New Zealand; as well as opportunities

(see Exhibit 3-9). It is interesting to note that several of the top buy industrial/distribution markets such as Bangalore, Ho Chi Minh City, Mumbai, and Beijing are not ranked in the top 25 global airport or ocean port cities, indicating strong domestic demand in an export-oriented region of the world.

**Apartment Residential Sector.** Rising per-capita income levels, an emerging middle class, and continued growth in urbanization rates are several factors fueling residential demand in many Asia Pacific cities. Mumbai and Bangalore take top honors in the buy category for apartment residential, with large hold ratings in cities such as Seoul, Jakarta, Sydney, Bangkok, and Beijing. Cities with the highest sell categories include Manila, Melbourne, Kuala Lumpur, Hong Kong, and Sydney.

in the Pacific Islands and in Sri Lanka.

Real estate investors and developers understand that real estate markets act differently from each other, yet at other times real estate markets, whether globally or regionally, are affected by the same macroeconomic factors. In other words, diversity (that which makes us different) and unity (that which makes us the same) coexist in real estate markets and in the capital markets. For example, growth in Asia Pacific economies is a unifying story, but not all of the Asia Pacific real estate markets share equally in terms of real estate demand, investment, supply, and pricing. Which cities are most alike or unlike each other?



An analysis of our survey respondents indicates that the 19 Asia Pacific cities fall into five general groups; there are unifying characteristics that describe each group. Based on each city's investment and development prospects and distributions of buy, hold, and sell for all property sector percentages, five clusters or groups of cities emerge.

The first cluster of cities are the top five investment cities, the cities where survey respondents generally agree that the investment prospects are good and the cities offer good opportunities to buy most property types. These cities include Osaka, Shanghai, Tokyo, Singapore, and Taipei. Average buy percentages across all property sectors in these cities are greater than the respective hold or sell percentages. "Go to these markets and buy if you can" is the message from our survey respondents.

A second group of cities falls clearly in the category of strong development markets. These include Ho Chi Minh City, Bangalore, and Mumbai, which are the first, second, and fourth highest-rated development markets in the survey, with Shanghai in third place.

A third group includes six cities whose investment and development ratings are not as high as those already mentioned, but they still receive solid buy signals from our survey respondents. These include Guangzhou, Bangkok, Beijing, Seoul, New Delhi, and Kuala Lumpur.

The fourth group consists of three mature markets that we characterize as hold cities. These include the highly transparent markets of Melbourne, Hong Kong, and Sydney. Finally, Manila and Jakarta are classified as challenging markets, with fairly low investment and development ratings and limited interest from buyers.

Diversity, complexity, maturity, and enticement—key themes for Asia Pacific cities in 2006 and 2007. The following section will briefly discuss survey respondents' ratings for each city. The order of the city discussions in each group is determined by the city investment ranking.

An Asian proverb provides clear advice to those entities charged with moving, prodding, or pushing Asia Pacific real estate markets toward market maturity in spite of the diversity and complexity associated with Asia Pacific cities: "It is not the knowing that is difficult, but the doing."

## Top Investment Cities

### Osaka

Numerous interviewees describe Osaka as a "best location"; obviously, our survey respondents agree as they rank Osaka as the number-one Asia Pacific city for investment. Osaka's industrial/distribution buy percentage is the highest among the 19 Asia Pacific markets, with retail and office buy percentages in the 60-plus range. Japan's economic recovery has facilitated increasing office and retail demand in Osaka, with positive rental rate movements in both sectors over the last year. Osaka now holds the distinction of having the tallest condominium property in Japan, although there are plans for several projects exceeding 50 stories in Tokyo.

#### Exhibit 3-11 Prospects for the Osaka Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Good	6.75	1
Development Prospects	Modestly Good	6.44	7
Blended Weighting	Good	6.60	3

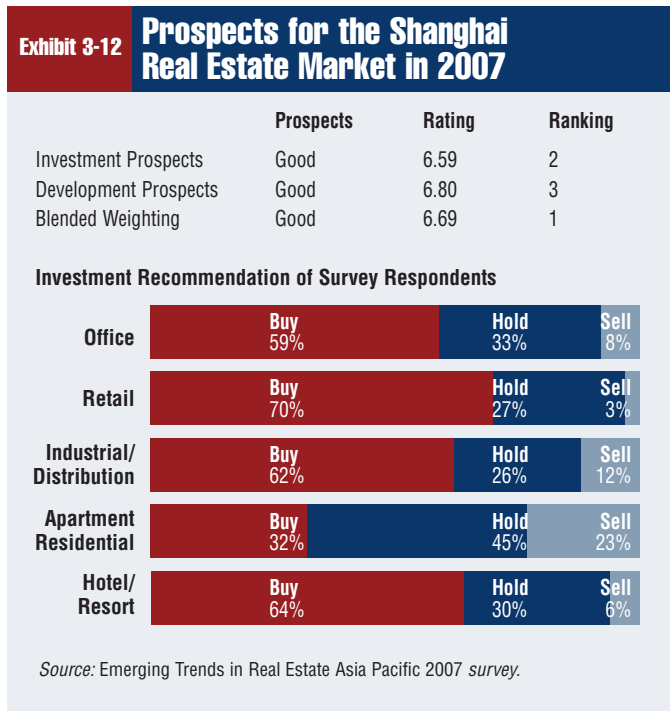
#### Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	63%	33%	4%
Retail	65%	30%	4%
Industrial/ Distribution	70%	26%	4%
Apartment Residential	46%	46%	8%
Hotel/ Resort	48%	43%	9%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

### Shanghai

Second ranking of the Asia Pacific cities goes to the Pearl of the Orient. Shanghai's development rating is considerably high in spite of current explosive growth in new commercial real estate supply in the market. Interviewees express unease regarding "... infrastructure under pressure . . . oversupply in the office



sector . . . and potential for a housing bubble,” which potentially explains the low apartment residential buy rating. Commenting on the industrial/distribution sector, one interviewee expressed the thought that the “. . . logistics sector is particularly attractive, especially in the Shanghai area. As China opens . . . and more goods are transported along the Yangtze, the need for more sophisticated supply channels is rising.” Retail is the number-one buy sector, and growing affluence in Shanghai should continue to propel this sector. According to several international architecture firms surveyed, “. . . development of satellite towns” surrounding Shanghai is in the planning stage.

## Tokyo

Tokyo is on a confirmed recovery path; our survey respondents rank Tokyo third in investment rating and also give the city significant buy percentages for industrial/distribution, retail, and office property sectors. Although “. . . yields have compressed,” there are still investment and development opportunities in Tokyo. There is cautious optimism regarding continued office demand through 2007, even with the threat of interest rate increases. The activities and transparencies of the JREITs have improved the overall quality and quantity of local property market information.

## Singapore

Singapore, ranked fourth in the investment rating, is primarily a buy-hold property market. According to our survey respon-



# Mumbai ranks among the top six buy cities for each property sector.

dents, the sell percentage for three property types is zero, with limited sell percentages for apartment residential and industrial/distribution. The market maturity of Singapore is evident; in fact, Singapore property firms are now exporting their management expertise and financial resources to other Asia Pacific markets. One interviewee claimed that “Singapore is safe, though you’re not going to make a high return.”

## Taipei

Taipei rounds out the top five Asia Pacific cities in the investment rating. The apartment residential sector has the highest sell rating in the market, and as one local interviewee confirmed, “Residential will be slowing down. Rental-producing properties will be the mainstream for the next two years, such as office, retail.” Our survey respondents would also include hotel/resort in that assessment due to the high buy rating for the sector.

**Exhibit 3-15** Prospects for the Taipei Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Good	6.50	5
Development Prospects	Modestly Good	6.07	13
Blended Weighting	Modestly Good	6.28	8

### Investment Recommendation of Survey Respondents

Property Type	Buy	Hold	Sell
Office	57%	36%	7%
Retail	50%	50%	0%
Industrial/Distribution	36%	50%	14%
Apartment Residential	36%	43%	21%
Hotel/Resort	64%	29%	7%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

## Strong Development Markets

### Bangalore

Bangalore is a “buy”; all property types for the city exhibit 50 percent or higher buy ratings. Survey respondents confirm such optimism, with buy exceeding hold and sell percentages for every property type, especially in the retail, apartment residential, and hotel/resort sectors. Several interviewees mention Bangalore as a “best location” for most commercial property types. Office vacancy rates are in the low single digits in the central, secondary, and periphery business districts, even with 10 million square feet (930,232 square meters) under construction, and retail looks to stabilize even with several major retail properties entering the market in 2006. Concerns over adequate and well-located land availability may have a short-term dampening effect with new supply in the apartment residential sector, thus supporting respondents’ high buy ratings for the sector.

**Exhibit 3-16** Prospects for the Bangalore Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.06	10
Development Prospects	Good	6.81	2
Blended Weighting	Modestly Good	6.44	7

### Investment Recommendation of Survey Respondents

Property Type	Buy	Hold	Sell
Office	54%	38%	8%
Retail	70%	23%	7%
Industrial/Distribution	50%	33%	17%
Apartment Residential	67%	25%	8%
Hotel/Resort	64%	27%	9%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

### Ho Chi Minh City

Regulatory risks and lack of institutional development are common themes expressed by our interviewees concerning Ho Chi Minh City. The city with the highest development rating also includes 50 percent-plus buy ratings for all property types. The entire spectrum of foreign demand, from foreign direct investments, multinational enterprises, and international retailers,



**Exhibit 3-17**

### Prospects for the Ho Chi Minh City Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.00	12
Development Prospects	Good	7.00	1
Blended Weighting	Good	6.50	4

#### Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	64%	36%	0%
Retail	64%	36%	0%
Industrial/ Distribution	64%	29%	7%
Apartment Residential	53%	47%	0%
Hotel/ Resort	73%	27%	0%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

is flooding into one of Vietnam’s major cities. With limited domestic capital lending sources for property development, expect a larger role of foreign property sources through 2007. A lack of transparency in the market is a concern.

**Exhibit 3-18**

### Prospects for the Mumbai Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.71	17
Development Prospects	Good	6.71	4
Blended Weighting	Modestly Good	6.21	10

#### Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	64%	21%	14%
Retail	79%	14%	7%
Industrial/ Distribution	57%	21%	21%
Apartment Residential	67%	25%	8%
Hotel/ Resort	75%	17%	8%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

## Mumbai

According to our survey respondents, Mumbai is a huge “buy.” Compared with the other 18 Asia Pacific cities, Mumbai ranks among the top six buy cities for each property sector—first in retail, second for apartment residential and hotel/resort, and third for the office sector. Interviewees continually mentioned strong economic growth, the increase in per-capita income levels, and rising urbanization to support property investment and development. According to our several international architectural and design interviewees, they “. . . have recruited management with Asian experience to lead . . . as well as developed internally skilled individuals” to staff growing practices in Mumbai. Several interviewees mentioned that Mumbai, and India in general, may be “too popular.”

## Solid Buy Cities

### Guangzhou

Buy ratings for all property types are below 50 percent, in stark contrast to several recent market reports and several interviews. “Guangzhou is . . . attracting interest now as prices there are relatively cheap for a first-tier city.” Guangzhou, the regional hub

**Exhibit 3-19**

### Prospects for the Guangzhou Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.24	7
Development Prospects	Good	6.67	6
Blended Weighting	Modestly Good	6.45	5

#### Investment Recommendation of Survey Respondents

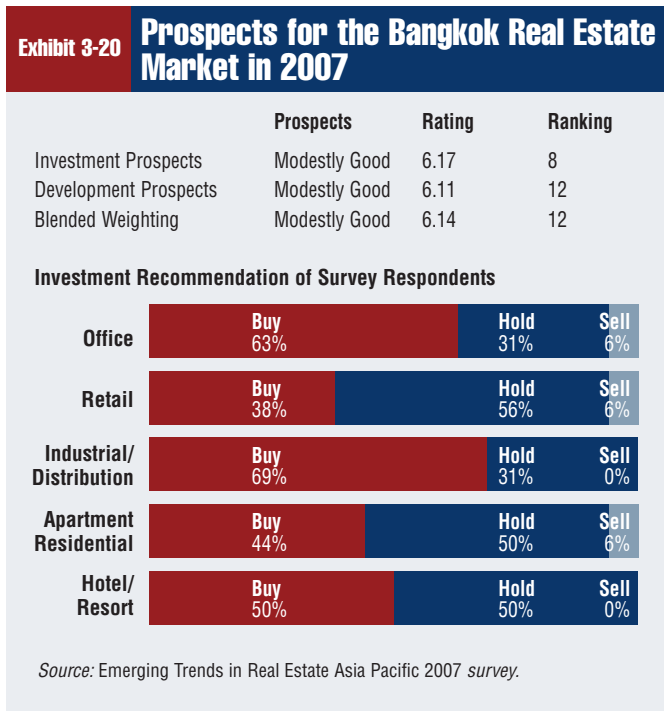
	Buy	Hold	Sell
Office	43%	47%	10%
Retail	45%	45%	10%
Industrial/ Distribution	46%	38%	15%
Apartment Residential	50%	38%	12%
Hotel/ Resort	44%	44%	12%

Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.

of double-digit manufacturing growth in the Pearl River Delta, has one of the highest per-capita income levels of the major cities in China, surpassing Beijing and Shanghai. Guangzhou's high development rating is indicative of future expectations and demand for property development in 2006 and 2007.

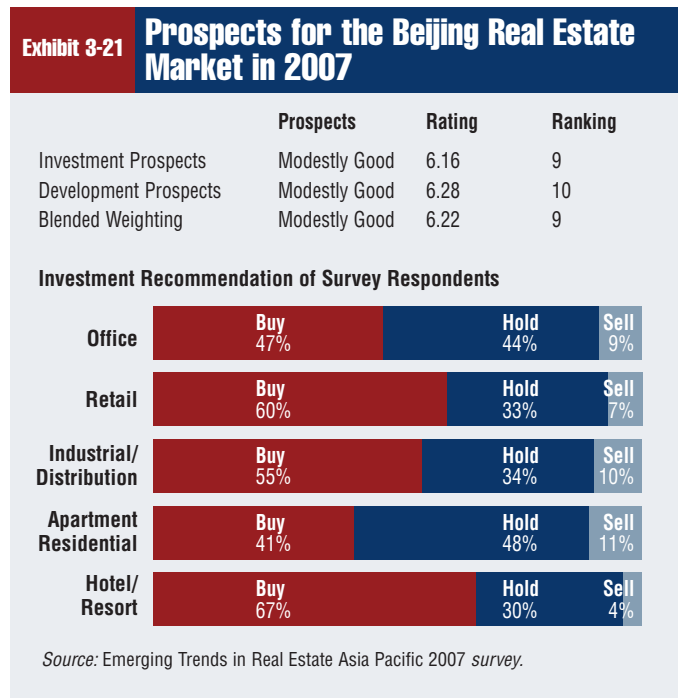
## Bangkok

The relatively new Bangkok Town Plan, enacted in May 2006, changed floor/area ratio regulations, open-space ratios, and setback requirements affecting residential and commercial development. It is unsure how this new public policy will affect future development, although coincidentally, new construction in 2006 across most property sectors in Bangkok has dropped significantly from 2005 levels. The Bangkok industrial/distribution sector received very strong buy ratings, second only to Osaka, implying a competitive investment market and value increases. Retail hold ratings are perhaps influenced by recent competitive openings in Siam Square and a wait-and-see attitude regarding the future sustainability of recent robust international tourism. Overall, many of the "ghost buildings" created by the 1997/1998 financial and real estate debacle are now reemerging as originally designed, or redeveloped into other property types.



## Beijing

One word describes the general sentiment of interviewees and survey respondents concerning Beijing: caution. Extraordinary growth in new supply for most major property types over the last several years has exceeded demand, causing stagnant if not falling rental rates with the slight exception for industrial/distribution. One interviewee expressed concern regarding "oversupply in the market, especially after the Olympics," while another international investor conveyed the idea that "opportunities in Beijing are beginning to be exhausted." Government incentives and subsidies appear to be working in the financial services office submarket, with the location of several international banking and financial service firms in the area.



Several interviewees with international architecture firms indicate a growing sentiment for new development in "... satellite cities ... around the major urban centers such as Beijing." High hotel/resort buy percentages may also mask an underlying interest in developing rooms for the upcoming 2008 Olympics.

## Seoul

Interviewees observe that local South Korean property developers are "... learning faster from overseas developers in their markets ..." and it "... applies in some CBD office markets, especially Seoul." Independent research confirms the trend of foreign property developers venturing with local domestic partners, par-

**Exhibit 3-22 Prospects for the Seoul Real Estate Market in 2007**

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.95	13
Development Prospects	Modestly Good	6.15	11
Blended Weighting	Modestly Good	6.05	13

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	47%	29%	24%
Retail	63%	25%	13%
Industrial/ Distribution	50%	38%	13%
Apartment Residential	20%	73%	7%
Hotel/ Resort	43%	36%	21%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*

**Exhibit 3-23 Prospects for the New Delhi Real Estate Market in 2007**

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.94	14
Development Prospects	Modestly Good	6.39	8
Blended Weighting	Modestly Good	6.17	11

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	57%	29%	14%
Retail	57%	29%	14%
Industrial/ Distribution	43%	43%	14%
Apartment Residential	54%	31%	15%
Hotel/ Resort	77%	8%	15%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*

ticularly in redevelopment projects in downtown Seoul. Other pan-Asian investors are concerned with the “political instability” in South Korea and its long-lasting real estate impact.

**New Delhi**

Excluding the industrial/distribution sector, there is a consistent theme to buy in New Delhi, according to our survey respondents. New Delhi’s development rating is respectable compared with that of the other Asia Pacific cities and the city ranks the highest among the 19 Asia Pacific cities for the hotel/resort buy category. The expected increase in tourism and business travel, in addition to large-scale development plans associated with hosting the 2010 Commonwealth Games, supports our interviewees’ cautious optimism for the New Delhi real estate market.

**Kuala Lumpur**

Similar to Jakarta, there was limited discussion concerning Kuala Lumpur from our interviewees. One interviewee mentioned that Kuala Lumpur is a high-potential target for mixed-use development, and another identified the Golden Triangle office submarket as a favorite investment market. More often, interviewees identified a growing REIT market in Malaysia—“REITs are a new concept in Malaysia and promise good investment,” “New REIT vehicles will increase, especially listed vehicles, allowing for smaller investors and less direct property investment by the

**Exhibit 3-24 Prospects for the Kuala Lumpur Real Estate Market in 2007**

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.94	15
Development Prospects	Modestly Good	5.67	16
Blended Weighting	Modestly Good	5.81	16

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	60%	33%	7%
Retail	33%	60%	7%
Industrial/ Distribution	36%	43%	21%
Apartment Residential	33%	27%	40%
Hotel/ Resort	40%	40%	20%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*



traditional families.” Although the sell percentage for apartment residential is significantly high, a respondent from a local development firm expects that housing “could be slowing down due to the increase of bank lending interest rates . . . housing,” yet continued to express optimism in regard to investment and development in “ . . . low-cost housing for low-income families.”

## The Hold Cities

### Melbourne

Although survey respondents ranked Melbourne in the top ten investment markets, the respondents clearly mark Melbourne as a “hold” market, with the exception of the high sell rating for the apartment residential sector. Hotel/resort, retail, and the office sectors have some of the highest hold percentages compared with other cities. The industrial/distribution buy percentage, higher than the other property sectors in Melbourne, will likely be tempered by increasing land prices for suitable industrial/distribution development in areas outside the city center. Melbourne, along with Sydney and Hong Kong, is one of the most mature and transparent markets in the Asia Pacific, and thus offers stability but not as much upside potential as many other cities.

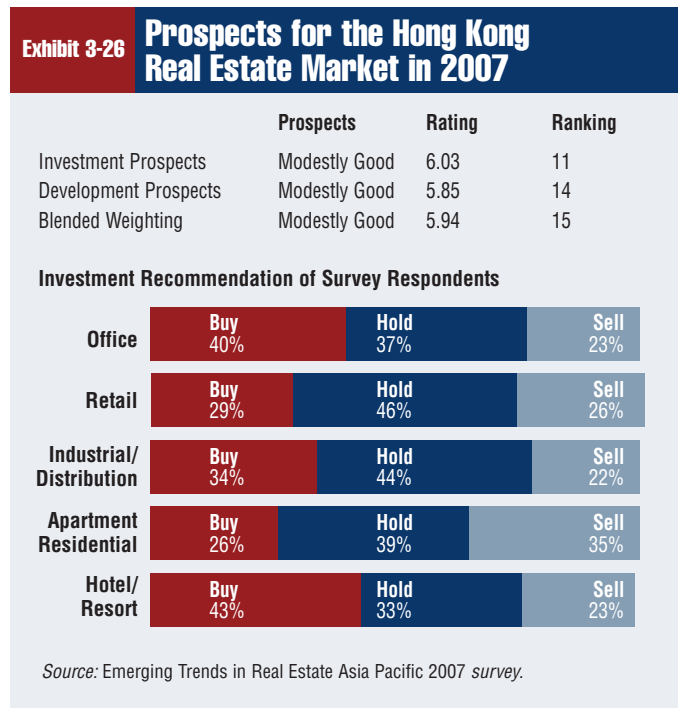


### Hong Kong

“Established, mature market,” are generally the remarks of experienced Hong Kong investors; “very interested” is the perspective of those interviewees who have yet to invest in China. Based on our respondents’ investment and development ratings, Hong Kong fits squarely in the middle of all the Asia Pacific cities as seen in Exhibit 3-1. Positive economic growth, supported by sustained growth in trade, tourism, and services, continues to increase property demand for all sectors. Yet, sell ratings for all property sectors are higher for Hong Kong than for most other Asia Pacific cities, potentially reflecting survey respondents’ belief that the market is peaking in its real estate cycle.

### Sydney

Sydney is a hold market, according to our survey respondents, with sentiment toward selling about equal to buying. The buy percentages are relatively low compared with those of other Asia Pacific cities, with none of the property sectors reaching 40 percent. Sydney’s low investment and development ratings effectively place the city in the lower-tier cities for investment. There is a recovery in the office market, especially in the central business district, due to increases of employment in professional business and financial services. One interviewee identified “ . . . poor performance in the Sydney housing market” as a major risk in 2007.



**Exhibit 3-27** Prospects for the Sydney Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.78	16
Development Prospects	Modestly Good	5.64	17
Blended Weighting	Modestly Good	5.71	17

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	30%	39%	30%
Retail	23%	59%	18%
Industrial/Distribution	35%	55%	10%
Apartment Residential	14%	52%	33%
Hotel/Resort	32%	58%	11%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*

**Exhibit 3-28** Prospects for the Manila Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Fair	5.00	18
Development Prospects	Fair	5.00	19
Blended Weighting	Fair	5.00	19

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	21%	57%	21%
Retail	15%	54%	31%
Industrial/Distribution	15%	38%	46%
Apartment Residential	25%	25%	50%
Hotel/Resort	46%	23%	31%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*

## Challenging Markets

### Manila

Although Manila ranks in the bottom tier of our investment ratings, local property firms have a “bullish optimism” that is “. . . brought about by the promising dollar remittance from overseas contract workers, the booming business processing outsource [BPO] industry as well as a more stable political and economic outlook.” The high buy rating for the hotel/resort sector is supported by one local interviewee who stated that “. . . tourism had shown encouraging signs with the improved peace and order situation,” which “. . . translates to an increase in hospitality development.” According to several property market reports, Manila is on a slow recovery and still exposed to political risks.

### Jakarta

Interviewees rarely mentioned Jakarta during discussions, and our survey respondents’ investment ratings effectively rank Jakarta last in the pool of Asia Pacific cities. One interviewee expressed a belief in the return of “old money” to Indonesia, while others consistently identified political risks as a major factor affecting real estate strategies. Buy percentages for all property sectors are among the lowest compared with those of the other Asia Pacific cities, with sell signals for apartment residential, industrial/distribution, and office property sectors.

**Exhibit 3-29** Prospects for the Jakarta Real Estate Market in 2007

	Prospects	Rating	Ranking
Investment Prospects	Fair	4.86	19
Development Prospects	Fair	5.21	18
Blended Weighting	Fair	5.04	18

**Investment Recommendation of Survey Respondents**

	Buy	Hold	Sell
Office	25%	50%	25%
Retail	8%	75%	17%
Industrial/Distribution	17%	58%	25%
Apartment Residential	9%	64%	27%
Hotel/Resort	27%	55%	18%

*Source: Emerging Trends in Real Estate Asia Pacific 2007 survey.*

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**Colliers International**

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Sam Crispin

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