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Institutional Real Estate Asia Pacific
Sponsor Interview

TH Real Estate
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The case for investing in Asia Pacific

Over the next few decades, the weight of economic power and structural megatrends will lean heavily towards the Asia Pacific region. By 2030, Asia Pacific, led by China, will account for nearly half of the world's output, more than 50 percent of the world's urban population growth and almost all of the top 50 global cities, with the largest forecast change in wealthy households. Therefore, the case for global institutional investors entering Asia Pacific, in order to build a sizeable core real estate portfolio, remains highly compelling, even more so in recent years, in light of heightened worldwide uncertainties following the Global Financial Crisis (GFC) in 2008. The region's more sturdy economic, demographic and political landscape provides risk-mitigating and diversification benefits, and a strong anchor to real asset values over the longer term.

How can investors benefit from investing in the Asia Pacific real estate market?

An allocation into Asia Pacific allows investors to add value to their global portfolio through intra-regional growth diversification and also benefit from the variances across economies within the region. A top-down macro perspective looking at real GDP growth since 1990 suggests that the enhanced diversification benefit of adding Asia Pacific into a portfolio, that also includes the US and Europe, is highly pronounced (See table, "Growth diversification between regions"). Rather than being led, Asia Pacific is now driving and outpacing world growth. The more attractive secular growth prospects for the region vis-a-vis many OECD countries — lower structural unemployment rate, well-buffered fiscal and FX reserve position, better infrastructure and transportation networks, among others — suggest Asia Pacific is better off standing alone and acting as a strong diversifier to growth in the US and Europe.

Furthermore, there are additional benefits to diversifying the inter-region allocation (See table, "Further diversification within the region"). For example, adding Australia into a portfolio that includes Japan, South Korea, Singapore and/or Hong Kong may help to enhance risk-adjusted returns meaningfully. Choosing a balanced and diverse portfolio, backed by economic growth cycles, across Asia Pacific is vital, as strong and resilient growth pulls income and capital value higher over the long term. Equally important, the more varied differences


Melbourne, Australia

"The region's stellar growth over the past decades has been concentrated on core cities, many of which are already among the world's biggest, most globally-competitive and resilient locations. Many more will rise to the fore in the coming decade, providing investors with even greater opportunities to tap into Asia Pacific's growing economic dominance."

— Chris Reilly, Managing Director, Asia Pacific

Growth diversification between regions

	US	Europe	Asia Pacific
US	1.00	0.72	0.08
Europe		1.00	0.33
Asia Pacific			1.00

Source: Oxford Economics, 2017
Note: Correlation of GDP growth between regions is measured between 1 and –1. 1 represents the most correlated and –1 the least correlated.

Further diversification within the region

	Australia	China	Hong Kong	Japan	Singapore	S. Korea
Australia	1.00	0.30	–0.01	–0.18	0.12	–0.10
China		1.00	0.47	–0.10	0.44	0.14
Hong Kong			1.00	0.57	0.84	0.59
Japan				1.00	0.63	0.53
Singapore					1.00	0.65
S. Korea						1.00

Source: World Urbanisation Prospects: The 2014 Revision, *UNPD; based on annual GDP growth, real terms in local currency (1990–2016)*
Note: Correlation of GDP growth between regions is measured between 1 and –1. 1 represents the most correlated and –1 the least correlated.

across global and regional markets, such as investable size, transparency, liquidity, tax and currency, can further help mitigate overall portfolio risk and enhance total returns.

Shenzhen, China

Why does TH Real Estate prefer city-level vs. country-level strategies?

Megatrends — notably urbanisation, rising middle classes, ageing populations, technology and the shift of economic power from the West — are having a major impact on the built environment and will have big implications on demand for real estate. While short-term performance of real estate will continue to be determined by economic cycles, investors looking for long-term value growth need to look at structural drivers of demand. The impact of these megatrends is much more notable at the city level, as opposed to nationally. Therefore, our business feels it makes more sense to develop strategies centred on cities, not countries. This approach is consistent with the way occupiers think about their requirements and representation. It means that compelling opportunities should not get missed due to negative country-level perception, and vice versa.

Does this philosophy apply to the Asia Pacific region?

Yes, it is the smart selection of cities, which are considered secularly resilient and sustainable from both an economic and environmental perspective, that can help deliver attractive long-term and stable returns. Many Asia Pacific cities are built along the same lines, and multiple regional capital cities also happen to be gateway and financial centres of their respective economies. For example, Seoul, Sydney and Tokyo account for roughly 20 percent or more of their respective national economies, and contribute even more to growth.

Every city has its own DNA geographically, culturally, economically and socially. This variance in the DNA of each city is what provides investors with investment choices and justification through economic-driven diversification. Investing in Hong Kong and Singapore is largely a bet on financial services growth. Hong Kong serves as a conduit for China's relatively closed capital market, whereas Singapore is the banking hub for private banking and South East Asia. Beijing and Tokyo may appear dissimilar in outlook, but they both provide density dividends underpinned by strong business concentration. Beyond the capital cities, there are strong investment prospects in other key secondary cities. For example, Melbourne is considered the sporting and cultural capital of Australia, drawing tourists as well as a strong cohort of international students, due to its quality of life and affordability. There can also still be diversification within industries, for example, Nagoya is a focus for the car industry, and Singapore is one for life sciences.

In the coming decades, the real economic power centres of the world economy are cities and metro areas. Cities are the platforms for innovation, entrepreneurship and economic growth. Seoul's economy is bigger than Malaysia, Shanghai outranks the Philippines, and as a nation, Tokyo would rank among the top 20 largest economies in the world. Furthermore, cities evolve; 20 years ago, backwater Shenzhen was a fishing village, however it has transformed into China's first special economic zone and key manufacturing hub, and it is slowly becoming the Silicon Valley of China. Against the current late-stage property cycle, investors still have many options to choose from. Picking cities with the right DNA that are secularly positive should help portfolio diversification and risk mitigation. For example, how about co-working space in Hong Kong, student housing in Melbourne, aged homes in Tokyo, and data storage in Singapore?

How do you decide which cities to invest in?

With about three quarters of the world's population projected to be living in cities by 2050, many more Asia Pacific cities will rank among the world's top urban economic success stories. By 2030, 11 of the biggest 25 cities globally (by output) will reside in the region, and Asia Pacific cities will account for 46 of the top 50 cities, with the largest changes in household wealth expected between 2010 and 2030. By 2030, Suzhou, Chongqing and Jakarta will replace Osaka, Nagoya and Seoul among the biggest Asia Pacific cities by economic output. During the same period, Asia Pacific cities will account for the top six spots globally with the highest number of middle-class (US$35,000–US$70,000 annual) households: Tokyo, Jakarta, Osaka, Shanghai, Chongqing and Beijing. Many rapidly-developing secondary cities in Asia Pacific today will complement existing core markets to provide institutional investors with a deeper and broader universe of good-quality investable assets for Tomorrow's World. So which, then, are the cities with the right DNA to prosper over the long term?

In designing core real estate strategies, a look at longer-term structural drivers of real estate performance is paramount, especially given the increasingly-complex market dynamics and evolving investor requirements. While a tactical analysis of market cycles remains important, understanding structural trends such as urbanisation, technology, ageing populations, migration and interconnectedness will also be key to preserving values and unlocking growth in cities over the long term. Our in-house city-filtering process is methodical, based on a set of robust and consistently-available global data, and is meant to identify future-proof, resilient cities backed by megatrends, which allows investors to look past short-term cycles. As thematic trends evolve, it is important to overlay hard factors with soft factors to derive a comprehensive set of resilient cities of the future. After all, while the building blocks of resilient cities are the same, the DNA of cities can be very different, yet crucial to their success. Given the later stage economic development of Asia Pacific compared to the US and Europe, global institutional investors may need to complement existing core cities with a basket of high-growth cities that build on core and diversify through growth. By 2030, the world's economic hierarchy will be very different from today's; therefore it may be time to look at the world differently, and invest in the future of Asia Pacific cities with a magnified prism.

What about China?

The rise of China has not only altered global trade patterns, but it has also placed China at the forefront of global capital and investment flows. China is now the world's largest economy in purchasing power parity terms. Rising urbanisation and an expanding middle class have also led to massive wealth creation and, subsequently, expanding consumer demand and tourism. By 2025, the number of middle-income households is set to increase by 130 million to 373 million — more than the entire population of the US.

By virtue of geographical proximity, many regional economies have benefited closely from China's rise, through foreign direct and portfolio investments, tourism and exports. An example is China's "One Belt, One Road" initiative. While world demand still plays an important role in driving Asia Pacific's growth, strong domestic demand growth — buoyant corporate and household balance sheets driving business investment and lifting consumer spending — will increasingly anchor the region's outlook in the coming years.

What investment opportunities are being seen across Asia Pacific?

Although still accounting for only 17 percent of the total, the level of investable stock across Asia Pacific has risen by 23 percent between 2010 and 2016, accounting for 64 percent of the growth in global office stock during the period. This trend of Asia Pacific, accounting for the biggest source of much of the increase in the global property universe, is set to continue in the coming years.

However, beyond a wider net of assets to choose from, structuring a global real estate portfolio through a robust strategic or tactical allocation also requires an in-depth understanding of the opportunity set in each of the selected markets. For example, in Tokyo, the level of Grade-B office stock accounts for roughly 75 percent of the investable universe. This is a result of the much earlier industrial development of the Japanese economy and a more diversified nature and scale of the city.

It comes as no surprise that modern, high Grade-B Tokyo offices form a substantial proportion of a typical global or domestic institutional real estate portfolio, given the liquidity, investability and smaller scale of the assets. While many large-scale office projects in the development pipeline in the Toranomon and Shinagawa districts are likely to lift the percentage of Grade-A office stock higher in the coming years, much of it will be held privately in developers' balance sheets

Tokyo, Japan

"As China continues to evolve and mature, the full weight of urbanisation, rise of the middle-class and rapid adoption of technology will tie in with 'One Road, One Belt' to help lift the region's economic prominence beyond its already-visible global influence in the coming decades."

— Joe Magrath, Director of Development, China

and is not likely to broaden the Grade-A investment universe significantly.

Similarly, for other mature core cities, such as Seoul and Singapore, the Grade-B investment universe ratio stands at around 60 percent and 70 percent, respectively. However, in Seoul's case, the dominance of the large chaebols and a relatively less transparent market, means that private domestic investors are more active in the Grade-B segment. However, in the more recent emerging growing office markets, such as Shanghai, Beijing and Melbourne, the rapid development of new, large-scale office buildings has allowed global institutional investors to more actively deploy capital into the Grade-A space. In Shanghai and to a lesser extent Beijing, newer office stock built by local developers is often sold into the market in order to recycle cash flows, particularly in the more decentralised districts.

By contrast, central Grade-A office assets in Hong Kong are held closely by the developers. Regardless of the price cycle, the investment ticket size in cities such as Hong Kong and Seoul tends to be much bigger than in the Australian cities (Grade-A) and Tokyo (Grade-B). The growth of the investable market across Asia Pacific will provide global investors with a wider pool of options. Beyond the size of the opportunity set, investors will also need to consider the depth of the market — liquidity and the typical size of transactions — to make the most meaningful capital allocation to achieve the best risk-adjusted returns.

What will Asia Pacific markets look like in 2018?

It is evident that the improving global cyclical growth momentum is expected to strengthen marginally, to 3.7 percent in 2018, up from 3.6 percent in 2017. In particular, the outlook for Asia Pacific has continued to improve (See chart, "Improving Asia Pacific oulook").

China continues to outperform expectations, as the economy is expanding around 6.7 percent at roughly the turn of the year, and is expected to slow only slightly to an average of 6.5 percent in 2018. With better comfort around growth, foreign exchange reserves and currency outlook, the slower growth during 2018 is likely to reflect tighter monetary policy to contain leverage and reduce local government financing risks.

"A deeper set of investment opportunities will surface in Asia Pacific over the coming years as markets continue to mature. However, investors will need to intricately understand the make-up and micro fabric of regional cities to navigate the more diverse landscape, compared to the US and Europe. In doing so, they should be able to successfully invest and achieve a diversified portfolio."

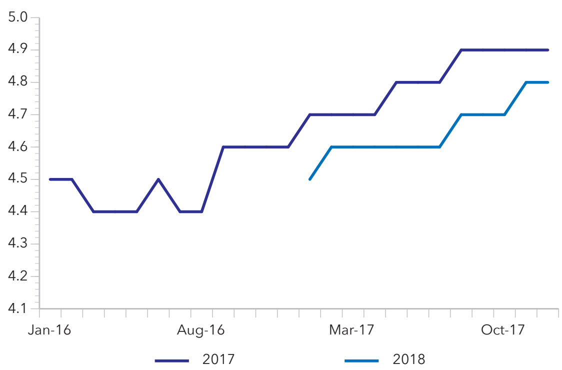
— Louise Kavanagh, Managing Director, Asia

The reflation in global manufacturing has also boosted growth in Singapore. The economy grew by 3.5 percent in 2017, double the initial official forecast, and real activity is expected to stay supported in 2018 from rising wage growth, through services-sector expansion on top of a better housing-market outlook (2018 consensus forecast at 2.9 percent).

Australia and Japan are likely standout performers throughout 2018. Australia's economy, projected to expand by 2.4 percent in 2017, is expected to pick up pace and increase to 2.8 percent this year. Business investment will continue to lead growth, consistent with strong corporate profitability, with some overspill from government infrastructure investment. Household sector dynamics will remain a cause for concern, owing to weak wage growth and high housing prices, although will not derail the steadily-improving growth momentum. Until consumer spending begins to show signs of improvement, the Reserve Bank of Australia (RBA) is likely to hold rates steady at 1.5 percent. Japan's economy likely grew by 1.5 percent in 2017, and while consensus economics is forecasting a marginally-slower growth of 1.3 percent in 2018, the balance of risks is broadly to the upside. This is due to labour market conditions continuing to tighten, with the November 2017 seasonally-adjusted jobless rate falling to 2.7 percent, the lowest since November 1993. With employment growth continuing to pick up, rising by 1.5 percent from a year ago in November 2016, the jobs-to-applicant ratio now stands at 1.56, the highest level in more than 40 years (See chart, "Upside potential to Japan's growth").

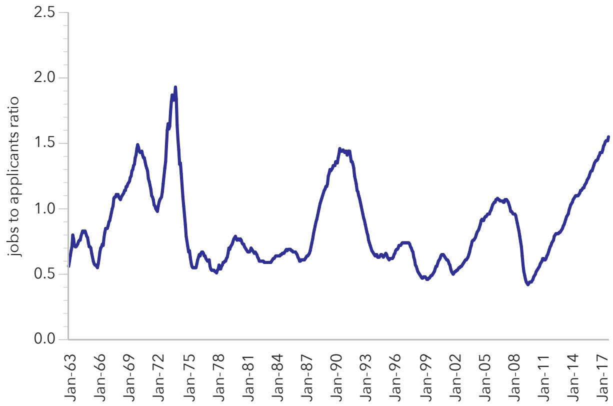
Furthermore, a better wage picture may help to anchor household consumption and lift consumer price inflation already standing at 0.9 percent, from January 2017. Improving inflationary expectations, in turn, will bolster the already very healthy corporate balance sheet, with a virtuous cycle of income and spending steering output growth higher. Finally, policy leanings are likely to stay very stable, with the Prime Minster of Japan (Shinzo Abe) likely to win the Liberal Democratic Party presidential election, while Governor Kuroda is expected to be reappointed Bank of Japan Governor.

Improving Asia Pacific outlook



Source: Consensus Economics, Dec. 2017.

Upside potential to Japan's growth



Source: Macrobond, January 2018

CORPORATE OVERVIEW

TH Real Estate, an affiliate of Nuveen, the investment manager of TIAA, is one of the largest real estate investment managers in the world with $107 billion in AUM. Managing a suite of funds and mandates spanning both debt and equity across diverse geographies, sectors, investment styles and vehicle types, we provide access to every aspect of real estate investing. With over 80 years of investing experience, and more than 500 real estate professionals located in over 20 cities throughout the US, Europe and Asia-Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise.

**AUM figures as at 30 September 2017*

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