

Asset and Wealth Management Research Digest

PwC | AWM Asia Pacific Market Research Centre

August 2018



REITs-ing new heights: The growth of the APAC REITs market and outlook for the future



REIT market in APAC

Real Estate Investment Trusts (“REITs”) first came on the Asia-Pacific (“APAC”) scene at the turn of the millennium. The first REIT, launched in 2001, was the Nippon Building Fund in Japan¹. Prior to this launch, REITs had largely been seen as a niche investment product in the antipodean nations of Australia and New Zealand where they were referred to as Limited Property Trusts (“LPTs”). In 1999, these LPTs numbered around 24 products with aggregate market capitalisation of USD 7.8bn.

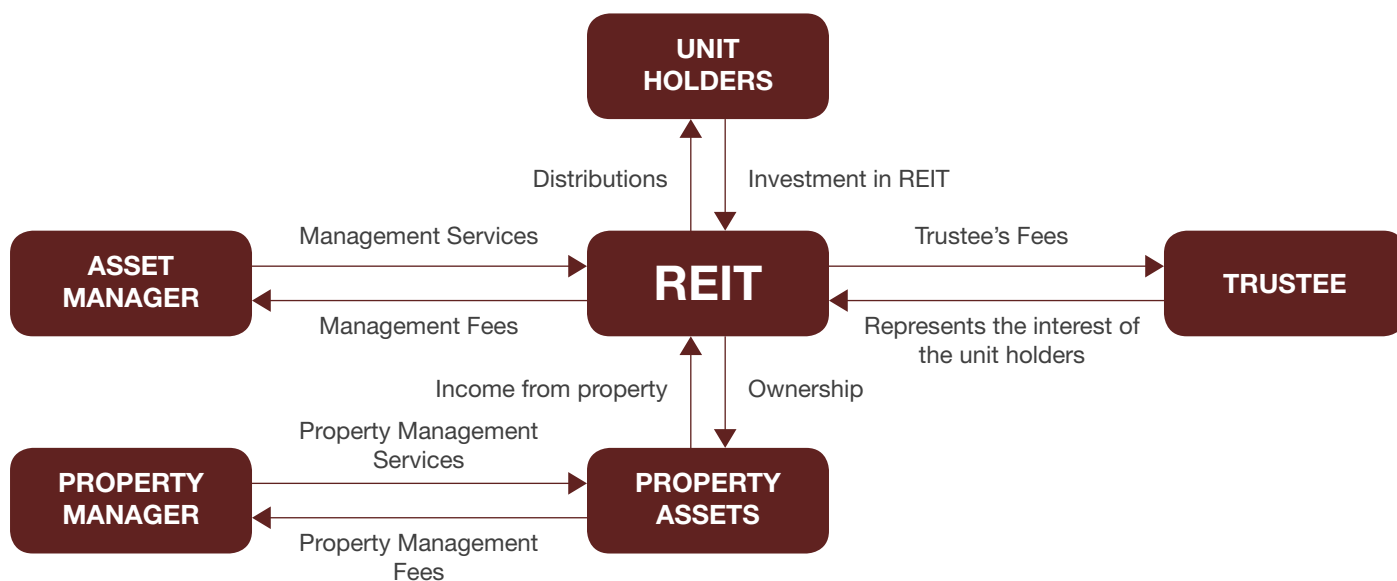
Jumping ahead to the end of 2017 and APAC REITs have come a long way. Numbers have grown to circa 250 and combined market capitalisation has swelled to reach USD 330bn. Within the APAC REITs market the main players comprise jurisdictions like Japan, Australia, Hong Kong, and Singapore, and smaller ones include Taiwan, Malaysia, and Thailand.

¹ <http://aspire.sharesinv.com/55155/why-an-asia-pacific-reit-strategy-makes-sense-for-singapore-investors/>



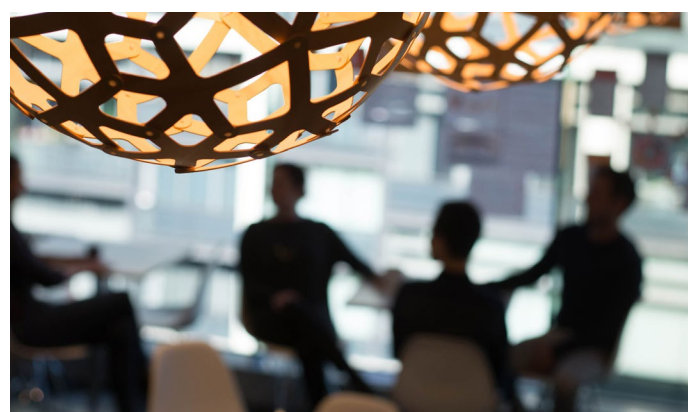
REIT structure diagram

Typical REIT Structure in Asia (External management)



More players are expected to enter the scene in coming years. China for instance, is one of the world's largest real-estate markets, and is yet to enter the REIT space, though regulators have made comments in 2018 about allowing mutual funds to purchase property, comments widely seen as the first tentative steps on the path to allowing full-blown REITs in the market.

As has been the case for development and innovation across human history, a significant factor in the growth and increased popularity of REITs over this time stemmed from disaster – manifested in the form of the Asian Financial Crisis of 1997. After this crisis, corporates found themselves with large debts and undervalued real estate holdings on their balance sheets. REITs provided these entities with a path to recapitalise their balance sheets and inject some vigour into the property market. Investors responded in kind to the flood of REIT products entering the market.



The success of REITs goes beyond a desire for entities to reinvigorate their balance sheets and turn their real-estate holdings into more liquid holdings. From a capital markets perspective, there are several compelling reasons to introduce REITs into the market:

- **They offer a means of diversification** – they allow investors to purchase property indirectly instead of purchasing a house or other residential, commercial, or industrial unit directly.
- **They can provide income stability** – many REITs have stipulations regarding the minimum amount of their earnings they can pay out. This leads to investors receiving a sizeable stream of income via dividends.
- **They can offer some measure of protection against inflation** – real-estate holdings provide a hedge against inflation and rents derived from REIT holdings can be less-sticky than other holdings which provides a hedge against inflation.

The above factors, and demonstrable growth across APAC, demonstrate the success of REITs in a relatively short period of time and potentially signal their long-term performance prospects. The outlook for REITs across APAC looks promising, with several markets potentially adopting measures to increase the attractiveness of REITs, and the largest untapped market, China, with a massive real-estate industry, possibly allowing for REITs to be introduced.

An examination on key REIT centres in APAC – Australia, Japan, Singapore, China, and Hong Kong, follows.

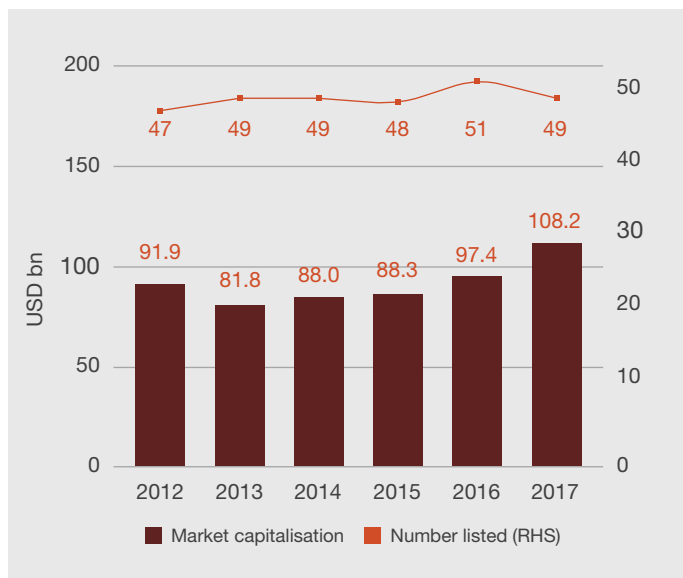
REIT market in Australia

It has been close to five decades since LPTs were first listed on the Australia Stock Exchange, they were renamed to REITs in 2008 to ensure consistency with international practice, and the market continues to grow. In Australia, REITs can be structured either as a unit trust or a hybrid structure of ‘stapled securities.’ Through stapled Australia REITs (“A-REITs”), investors can own units of a property trust, as well as shares of the fund company managing the trust.

From an investor’s perspective, stapled securities have the potential to provide additional income from related operations of the fund company such as rental revenue and management fees, as well as lower the amount of taxes paid due to the receipt of tax deferred distributions. As a result, they have grown in popularity in recent years, and account for the bulk of A-REITs available today.

As seen in Chart 1, the A-REITs market has experienced consistent year-on-year growth since 2013. While there is a huge suite of REITs available in the market, investors generally only select a limited group of A-REITs – as of end 2017, the 10 largest A-REITs alone were responsible for 81% of A-REITs market capitalisation.

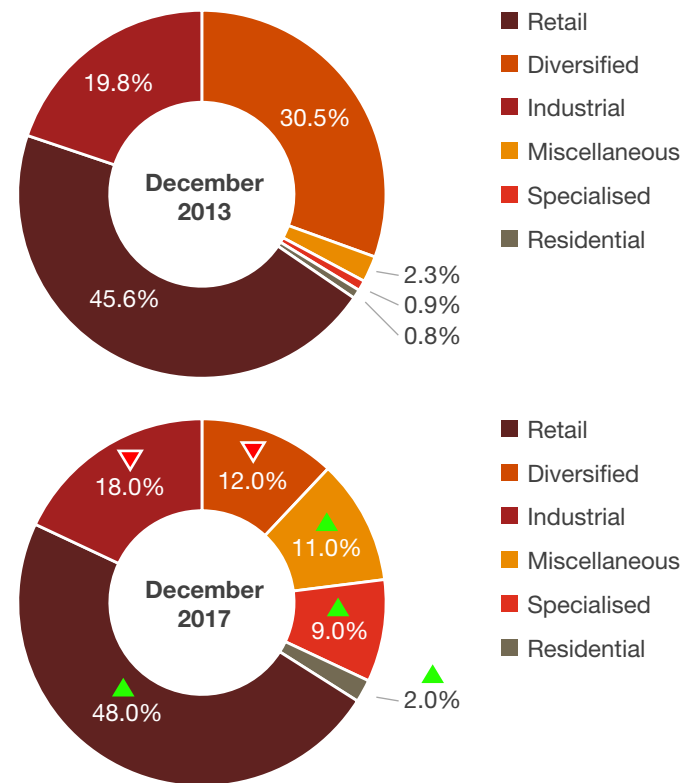
Chart 1 - Market capitalisation and number of Australia REITs, 2012 - 2017



Source: ASX, PwC analysis

Though the market is fairly concentrated, we have noted the rise of a new asset class – specialised properties – in recent years. In 2013, REITs investing in specialised properties made up less than 1% of funds managed by A-REITs, but have since risen to account for 9% of assets as seen in Chart 2. These specialised REITs typically invest in niche properties, which tend to be smaller in size, and many of these have higher long-term potential than traditional assets. Examples of niche properties include childcare and early development centres, healthcare facilities, data centres, and self-storage centres².

Chart 2 - Sector classification of A-REITs by funds under management, 2013 & 2017



▲ Represents an increase in market share between Dec 2013 and Dec 2017
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Source: ASX, PwC analysis



² <https://www.asx.com.au/education/investor-update-newsletter/201504-rise-of-the-specialised-areit.htm>

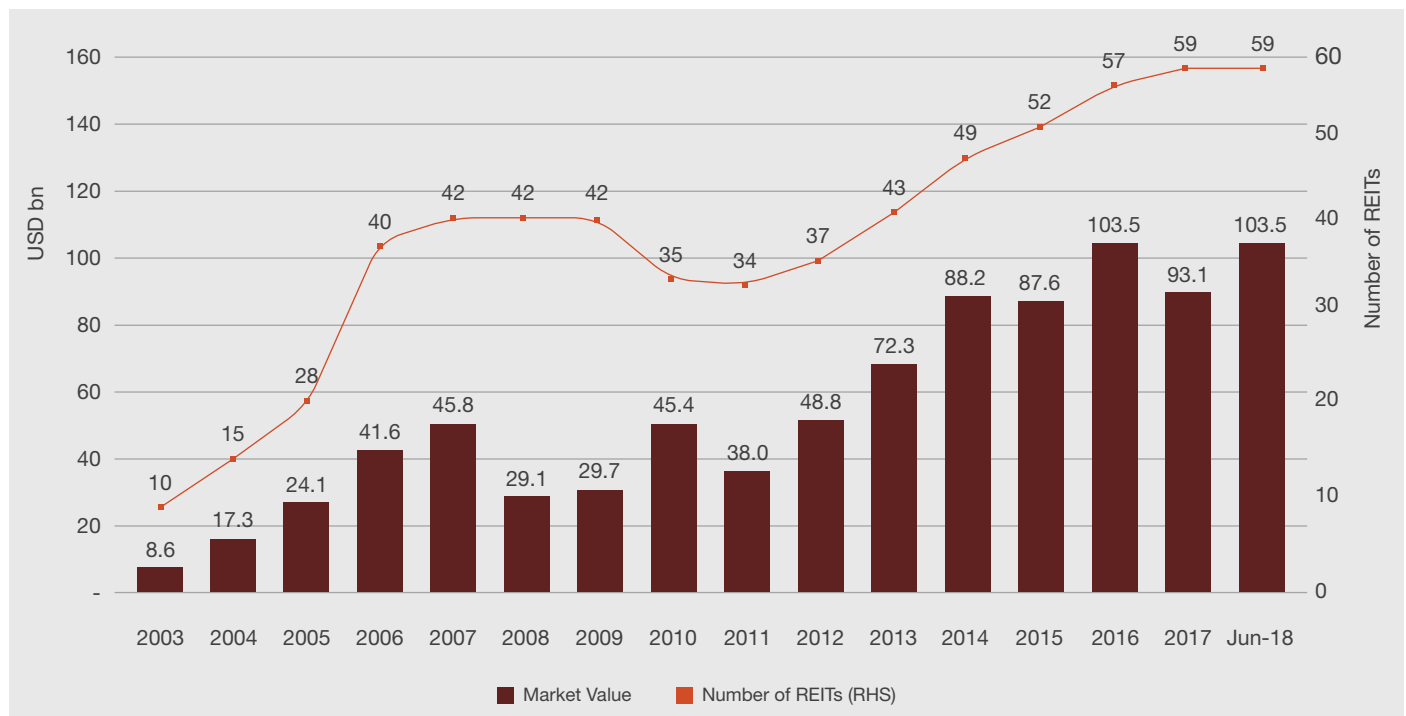
REIT market in Japan

Shifting focus across the Pacific Ocean, we move towards the second largest REITs market in the APAC region – Japan. As of June 2018, there were 59 Japan REITs (“J-REITs”) with a total market capitalisation of USD 114.1 bn. Up until 2008, J-REIT managers were not allowed to invest in offshore properties, resulting in a pool of heavily concentrated REITs investments in the country. Though the local regulator has since allowed asset managers to venture beyond the Japanese market, most players remain fixated on local real estate.

Due to a heavy reliance on local property conditions, the Japanese REIT market has seen major swings, particularly during the Global Financial Crisis in 2008, and Tōhoku Earthquake in 2011. In fact, the aforementioned events led to a fall in market value by 36.4% and 16.3% in 2008 and 2011 respectively, as shown in Chart 3.



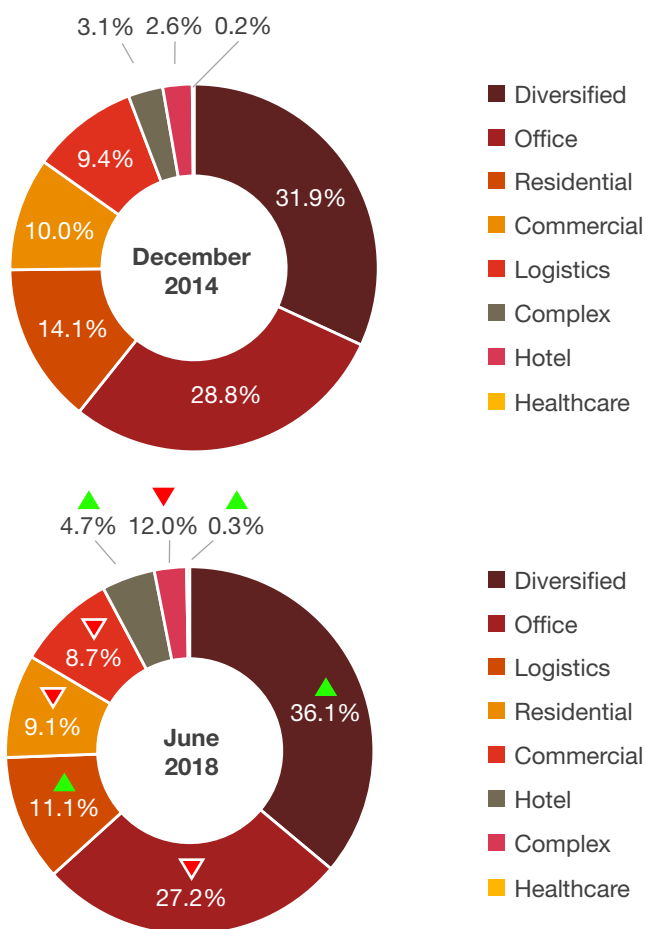
Chart 3 - Market value and number of Japanese REITs, 2003-June 2018



Source: Toushin, PwC analysis

That being said, the J-REITs market is showing signs of diversification, as illustrated in Chart 4. Since 2010, J-REITs have invested in local hotel and logistics facilities, which have mushroomed on the back of increased tourism and e-commerce activities. At the same time, aggregate investments in J-REITs have picked up in recent years, driven largely by the asset purchasing spree of the central bank. Local investors, plagued by negative interest rates, are also turning their attention to the REITs market in search of higher yields.

Chart 4 – Sector classification of J-REITs by market capitalisation, Dec 2014 & June 2018



▲ Represents an increase in market share between Dec 2014 and Jun 2018
 ▼ Represents a Decrease in market share between Dec 2014 and Jun 2018

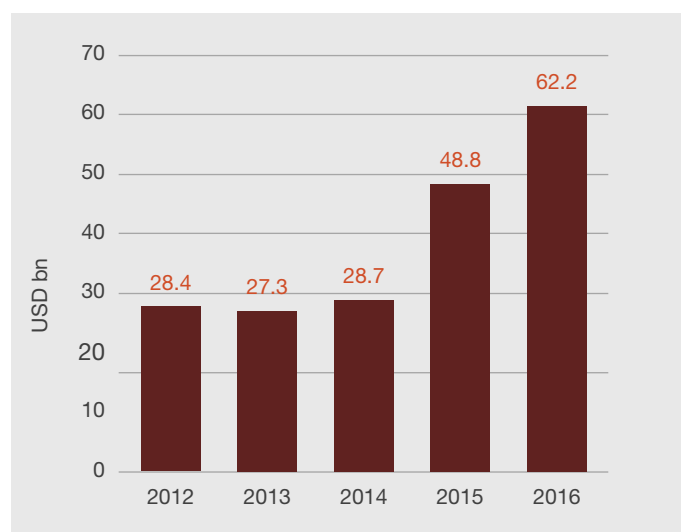
Source: Japan REIT Inc., PwC analysis



REIT market in Singapore

Against this backdrop of past success and future potential, Singapore stands out. Despite a comparative small scale, measuring 50km from end-to-end, and paucity of land area, 721.5km² compared to other economies in the region (with the notable exception of Hong Kong), the Singapore REITs (“S-REITs”) industry has managed strong growth since its launch and nowadays ranks as one of the largest in Asia, behind only Australia and Japan. To date, there are 41 S-REITs with 36 listed on the Singapore Exchange (“SGX”) and total market capitalisation increased by more than two fold to from 2012-2016 to now stand at USD 62.2bn.

Chart 5 – S-REITs market capitalisation, 2012-2016

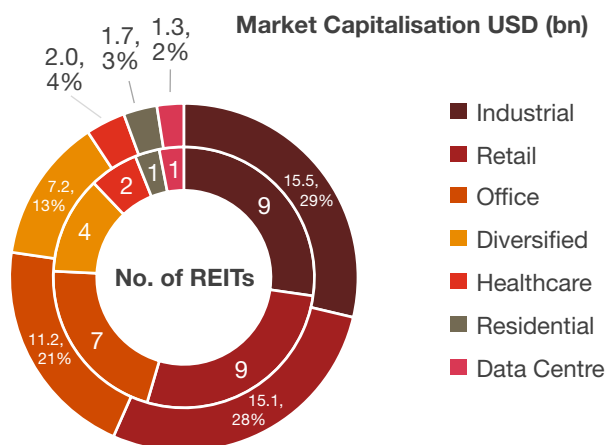


Source: Preqin

The REIT regime in Singapore was officially launched in 1999 with the first S-REIT, CapitaLand Mall Trust, being listed on the SGX in 2002. In 2017, the first Singapore focused REIT ETF, Lion Philip S-REIT ETF, was listed on SGX.

Over time, investor demand and REIT specialisation has seen specific REIT sectors emerge in the market. These specialist REIT sectors now encompass office / commercial, retail, industrial, hospitality, and healthcare, among others and offshore-specific options.

Chart 6 – S-REITs market capitalisation by sector, 2018



Source: Bloomberg

In 2018, 76% of S-REITs contained foreign properties and 12 of these S-REITs comprise entirely of foreign properties. This leads to Singapore having an idiosyncrasy whereby the number of foreign-focussed REITs exceeds the number of domestic-focussed REITs. This is unlike the APAC REITs industry in general as most other countries have a majority of domestic-focussed REITs. In Japan for instance, despite lifting the restriction on foreign assets in 2008, only one Japanese REIT has acquired foreign properties.

From a regional perspective, 73% of S-REITs holds only properties in Asia Pacific and 15% of S-REITs have a global exposure with no specific geographical focus. Investors can achieve regional diversification through investment in S-REITs.

REIT market in China

The origin of Chinese REITs (“C-REITs”) can be traced back to 2005, when the first red-chip – a term for companies based in China, registered internationally, and listed in Hong Kong – REIT, Yuexiu REIT, was launched on the Hong Kong Stock Exchange. The structure of the Yuexiu REIT was relatively simple: four British Virgin Islands companies held the four domestic buildings. Despite existing for over a decade, the development of the sector stagnated until the emergence of onshore REIT-like securities – as REITs are currently not allowed in China – in 2014. Constrained by regulations, namely high transaction taxes and restrictions on mutual funds investing in commercial property, the prototype onshore REITs are not similar to traditional equity REITs. They are classified into two categories:

Quasi REIT – these are REITs launched by private equity funds and are not able to be held by mass-retail investors. They are not listed and have been compared to crowd-funding efforts with the intent of buying specific property or properties. They have also not been exposed to issues REITs in more developed markets face like taxation and the distribution of dividends.

Pre-REIT – pre-REITs are held under the Private Fund Manager regime in China and hold commercial properties.

Accordingly, they are limited to 200 qualified investors, either institutional investors or HNWI broadly speaking, which impinges their liquidity.

As pre-REITs are essentially debt-vehicles, China’s deleveraging efforts, and lifting of other regulatory restrictions, may accelerate their transition to proper REITs.

There is great excitement that China’s authorities will authorise REITs in 2018 or 2019, with some commentators estimating total REIT issuance at USD 1.9tr. Were REITs to eventuate, China may prove relatively unique in having a strong showing of residential REIT products in addition to the usual office building and shopping-mall themed ones.

REIT market in Hong Kong

Latest data shows there are ten active REITs in Hong Kong, one is suspended, with a combined market capitalisation of circa USD 35.7bn. Of these REITs, six are predominantly focussed on Hong Kong properties and four are red-chip REITs focussed on China. The first RMB-denominated REIT, the Hui Xian REIT, was listed in April 2011, though no new RMB denominated REITs have followed it. The investment holdings of Hong Kong’s REITs are fairly broad, with office buildings, shopping malls, hotels, and others covered.

The Hong Kong REIT market continued developing in 2017 and outperformed the Hang Seng index when looking at dividend yield, the dividend yield of the Hang Seng REIT Index was 5.6% while the Hang Seng index amounted to 2.9%. This would generally be attributed to REITs having a higher pay-out ratio than other listed companies. Hong Kong’s strong property market and rising rents all contribute to REIT performance.

Despite starting at around the same time as other APAC REIT centres like Singapore and Japan, Hong Kong’s REIT market has not developed in the way many may have imagined given the similarities it shares with leading REIT centres. Currently, Australia and Japan account for approximately 33% of APAC REITs each, Singapore comes in with circa 20%, and Hong Kong with around 10%³. Conversely, Hong Kong’s listed real estate market is the third largest in the world, behind the USA and Japan, and Hong Kong’s Link REIT is the largest in the APAC region. Such dichotomies should not be interpreted as meaning Hong Kong has been unsuccessful in the development of its REITs programme, more that the success has not been as evenly distributed as it could be.



³ <http://www.ejinsight.com/20171106-how-hong-kong-reits-can-boost-their-growth/>

Hong Kong has taken some steps to improve overall REIT performance in the territory. In 2014, it enacted regulations that would enable REITs to invest 10% of their asset value in development projects. The theory behind this was that it would enable REITs to record higher growth on these projects but the high cost of land in Hong Kong has meant that smaller REITs have not benefited as much as larger ones. Commentators suggest raising the limit to 25%, or follow the example of Australia and have no development limit.

Challenges and threats to established REIT centres

Strong competition

Recent years have seen increasing numbers of emerging economies in APAC and the sub-continent take steps towards developing their own REITs regimes. These include countries like China, as outlined above, India, and Indonesia. Should these and other economies develop competitive REITs regimes, this would have a detrimental impact on the growth of REITs in developed economies, particularly those which are highly reliant on overseas property holdings. The future success of developed-economy REITs will depend on how their regulators and key industry players respond to the intense competition from other mature REIT centres and emerging ones.

Rising interest rates

Emerging and developed markets across the world are generally subject to the whims of the USA's monetary policy in one form or another. Hong Kong for instance has its currency pegged against the greenback, China has the USD in the basket of currencies its currency is benchmarked against in a trading band, and, historically, the Singapore Inter-Bank Offer Rate is highly-correlated to interest rates in the US.

Table 1 – Rising Federal Reserve rates

	Implied Probability of US Interest Rate Hike	1.75-2.00 (%)	2.00-2.25 (%)	2.25-2.50 (%)	2.50-2.75 (%)	2.75-3.00 (%)	3.00-3.25 (%)	3.25-3.5 (%)
Sep-18	86.20%	13.80%	72.40%	13.80%	0%	0%	0%	0%
Dec-18	94.90%	5.10%	35.20%	48.60%	10.60%	0.50%	0%	0%
Mar-19	97.60%	2.40%	19.00%	40.00%	30.20%	7.70%	0.70%	0%
Jun-19	98.60%	1.40%	12.00%	30.50%	33.30%	17.40%	4.60%	0.60%

Source: Bloomberg

Conclusion

REITs across APAC have grown impressively since 2000 when they were little more than niche property investment vehicles in Australia and New Zealand. Nowadays, they are an incredibly popular investment class and the APAC market landscape has changed dramatically. Australia still remains a key REIT market but Japan, Singapore, and Hong Kong have also emerged. These centres are now watching other emerging REITs centres like China with interest and trepidation, but ensuring that their REITs regulatory and taxation regimes remain competitive is the best defense against these challenges. Indeed, the threat of competition may accelerate regulatory and industry development in the established centres to ensure they retain their position.

While there are potential headwinds for the APAC REITs sector, in terms of internal industry forces and external threats from emerging REIT centres, the outlook remains bright and local regulators should be able to navigate their way through the challenges to come, piloting their respective REITs regimes soundly into the future.





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