Prudential Real Estate Investors

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Market Perspective

Although economic growth for 2005 will likely fall below that achieved in 2004, Asia should still expect relatively robust growth this year, led by its two largest economies, China and Japan. China's first-quarter 9.4% annualized GDP growth rate was surpassed by its 9.5% performance in the second quarter. Despite the government's best efforts to slow economic growth to 8% by restraining lending and investing, China looks as if it will achieve 9% economic growth this year.

China's revaluation of the yuan has far-reaching implications for the region. The revaluation itself was only a slight 2%, from 8.28 yuan/dollar to 8.11, but the currency will now move within a daily band of +/- 0.3% versus the dollar, depending on supply and demand. China's export growth slowed during the second quarter, and although this might simply have been a blip, a stronger yuan could hurt exports in the long run.

In Japan, a rise in the *tankan* survey at the end of the quarter provided optimism that the economy might really be in a recovery phase. The all-industry business conditions index continued to increase, with most firms forecasting generally favorable business conditions over the next few months. The index at the end of the quarter stood at its highest level in 14 years.

Japan's inventory levels have decreased, and firms are now more confident in their financial position. Improved business profitability finally translated into higher incomes. June saw the first annual increase in nominal incomes in seven years. Japan's unemployment rate now stands at a six-year low. Both corporate and consumer spending are buttressing domestic demand, and foreign direct investment has reached a record high, eclipsing Japanese investment abroad for the first time in the post-war era.

The smaller Asian economies are projected to have mixed results in 2005, but they are all experiencing commendable growth. South Korea, Hong Kong, Thailand and Singapore are on track to achieve 4% to 5% annual GDP growth in 2005. Confidence among South Korea's manufacturers fell to a five-month low in June on concerns that a domestic economic recovery will fizzle. This might cause the government to approve a supplemental budget to help prod growth in Asia's third-largest economy.

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In Hong Kong, domestic demand is expected to counterbalance a decline in exports, although not enough to slow economic growth relative to 2004. The moderate GDP growth forecast for Thailand stems largely from economic difficulties faced in the first half of 2005, including a drought, which hurt the crop supply, and rising energy costs. Forecasts for Singapore have also been revised downward due to unimpressive economic performance during 1Q05. The financial services sector is still expected to perform well, making the economic downturn less severe.

Malaysia, Indonesia and India have experienced more robust economic growth through the first six months of 2005 and are targeting 5% to 7% annual GDP growth. Malaysia's trade-oriented economy performed well in early 2005 thanks to strong manufacturing and services production. Despite government cuts in spending on infrastructure to reduce its budget deficit, GDP growth is still anticipated to be above 5% for 2005. In Indonesia, exports and corporate investment spurred the economy. China's increasing demand for natural resources and metals has helped keep the economy growing. In India, strong manufacturing and services performance has more than compensated for disappointing agricultural results. Thus, India's economy is still well positioned to achieve 7% GDP growth in 2005.

Public Markets

The Asian listed property markets rebounded in 2Q05. After falling more than 4.1% in the first three months, listed property firms in the Asia-Pacific region delivered average total returns of 3.1% in the second quarter, according to the S&P/Citigroup BMI Property Index. The REIT sub-index, which includes both Asian REITs and Australian listed property trusts (LPTs), continued to outperform non-REIT listed property shares as investors remained focused on current yield. Asian REITs and Australian LPTs returned more than 3.8% in the second quarter, pushing the average year-to-date total return to about 0.4%. Over the last one-year and three-year periods, Asian REITs and LPTs have returned nearly 29% per year.

Despite the sharp deceleration in listed property returns in the first half of this year, the Asian REIT market continues to expand rapidly. Japan's J-REIT market has seen a wave of new listings this year, with two IPOs in the second quarter and another four in July, pushing the total J-REIT market to 22 companies, with an equity market capitalization of about $25 billion. Although the J-REIT market is still relatively small compared with Japan's significantly larger non-REIT listed property market, J-REITs have grown quickly since their introduction in early 2001. As in other Asian countries, the combination of low yields and a property market recovery has fueled the growth of J-REITs. As of the end of 2Q05, the average dividend yield for J-REITs was about 3.5%, or nearly 230 bps higher than the yield on 10-year Japanese government bonds.

Listed property shares in Singapore continued their strong performance during the quarter, with total returns of about 7.7%. Year-to-date through June, Singapore property shares delivered average total returns of nearly 12.8%, well ahead of all other countries in the Asia-Pacific region of the BMI Property Index. The S-REIT market continues to attract investors and property owners/managers. The sixth S-REIT, MapletreeLog, debuted in July, bringing S-REITs' total equity market capitalization to more than $6 billion since the first one was launched in 2002.

Although S-REIT yields have compressed sharply during the market's brief existence, falling from about 7% in 2002 to about 4% today, they still offer an attractive spread to 10-year government bond yields, which were about 2.6% at the end of June. The Monetary Authority of Singapore (MAS) has taken steps to ensure that S-REIT shares and the structure itself remain attractive to investors and competitive with other property investment vehicles. Earlier this year, MAS increased gearing limits for S-REITs to 35% from 25% and waived the stamp duty for properties acquired by S-REITs, making them more competitive in the transaction market for assets, while reducing the tax rate for non-resident investors to 10% from 20%.

Malaysia also launched its REIT market this year. The first M-REIT, Axis REIT, began trading on August 3, with an impressive debut. The attention garnered by Axis should also benefit the other publicly traded property firms in Malaysia, which have been largely ignored by investors.

REITs are also gaining momentum in other Asian countries. Most importantly, perhaps, the much-anticipated Link REIT, which would be Hong Kong's first REIT, appears to be back on track for an IPO later this year, after clearing the final legal hurdles that have delayed the listing since late 2004. While the Link REIT IPO will be an important milestone for the Hong Kong listed property sector, recent regulatory changes governing Hong Kong REITs should provide a catalyst for more REIT listings. Specific changes include the removal of restrictions on owning assets outside Hong Kong and an increase in the maximum allowed gearing to 45% from 35%.

With relatively few opportunities for investors to find attractive, yield-oriented investments and with strong pent-up demand for secure cash yields, listed property shares should continue to find favor with individual and institutional investors in Asia, particularly as the Asian REIT market expands. While rising long-term interest rates and new supply could slow the growth of the Asian REIT market, economic growth and the ongoing property market recovery should provide opportunities for income and dividend growth.

Private Markets

Office

The economic growth sweeping the region is translating into increasing demand for office space. Because this demand has largely come from service-sector companies, financial centers, such as Tokyo, Hong Kong and Singapore, have benefited the most. However, the other major office markets in the region have also seen an increase in demand. This strong demand and limited supply caused rents to rise in 2Q05.

Leasing activity in Tokyo during the second quarter was robust, particularly in the main wards of central Tokyo. The average Class-A rent rose 4.1% versus the first quarter. With economic growth likely to result in increased future demand, coupled with limited Class-A supply, rents are likely to continue to rise. Investment interest in Tokyo office remains strong, although competition is fierce because of the limited supply available for purchase. Yields on property in Tokyo's main central wards declined marginally during 2Q05 as values increased about 7.0%.

In Hong Kong, the office market also performed well during the second quarter, with rents rising 14.7% compared with the first quarter. Demand for space came from both new and existing tenants. While the CBD continues to experience the strongest rent growth, surrounding locations are also benefiting, as several firms consider these areas an attractive, cheaper alternative. Yields were flat during the quarter as the increase in property values essentially kept pace with the increase in rents.

Beijing and Shanghai reaped the benefits from new office demand and limited new supply. Foreign tenants continue to be active players in these markets, driving rents up versus the first quarter, by 4.7% in Beijing and 3.4% in Shanghai. Foreign investment in office buildings is growing, although local investors still dominate the landscape. However, in the long term, the revaluation of the yuan will directly raise the value of Chinese real estate relative to other currencies. As a result, international investment should increase, possibly putting downward pressure on yields, which rose in Beijing but declined in Shanghai during the quarter.

Demand for office space in Seoul remained muted. However, low vacancy rates, particularly in the best office buildings, still supported rent levels, resulting in a slight 1.6% increase compared with 1Q05. During the second quarter, nine buildings were sold for a total of $368 million. The resultant upward pressure on values caused yields to decline slightly during the quarter. Demand for office investment has come largely from domestic sources. Through the first half of 2005, 28 office buildings were sold; domestic investors purchased 21 of them.

In Singapore, many tenants expanded and upgraded their office space during the quarter, reducing the amount of available space and pushing rents 6.0% higher than in the first quarter. The rising tide of the active leasing market raised all boats, as non-CBD and Class-B buildings also experienced rent growth. As office fundamentals strengthen, office investment in Singapore looks increasingly attractive.

The government of Singapore also announced plans to undertake a series of large-scale projects to inject vibrancy into the city-state. These projects include a 4.7-million-square-foot business and financial center in the heart of the CBD. The plans also call for the creation of integrated resorts with casinos and additional retail along the famous shopping belt of Orchard Road.

In Bangkok, rents rose 9.3% versus first-quarter levels. Widespread demand was met with limited Class-A supply. Although some potential tenants are now seeking space in lower-grade buildings in the CBD, the new rapid transit system should create demand for space in the non-CBD areas. Although property values rose during the quarter, the strong increase in rents caused yields to rise as well.

Residential

Leasing activity remained strong during the quarter, driven by the expansion of many multi-national firms in the region. Sales of luxury residences also increased during the quarter although not uniformly throughout Asia.

In China, the government has encouraged banks to request larger down payments for the purchase of residential property (30% versus 20%). Despite these measures, demand for purchases and rental units in Shanghai remained strong. So much so that for the first time China applied capital gains tax to Shanghai property held for less than 12 months to quell speculation. Rental rates fell slightly versus the first quarter. In Beijing, the relatively large number of completions in the past few years has resulted in high vacancy rates. Nonetheless, rents have held up and have actually risen slightly compared with first-quarter levels.

The yuan revaluation is likely to decrease yields for luxury residential buildings over the long term as these assets become more attractive to, and more frequently purchased by, foreign investors. The implications for the mass residential market are murkier. The aforementioned government measures to slow investment have succeeded, with a couple of notable exceptions, such as Shanghai. Government policies, along with the traditionally slack summer season, have slowed transaction activity in many cities, and many developers have delayed new projects. The traditional peak season for residential is late summer/early fall, so activity during that period will provide a good indication of the true strength of the market.

After a traditionally slow first quarter, the rebound in luxury residential sales during the second quarter has reduced the space available for lease in Hong Kong. Supply remains tight as owners hold back some of the space available for sale. Potential tenants are now feeling more pressure to make timely leasing decisions. Due to declining property values, yields increased during the quarter. Mortgage rates continued to rise in 2Q05, which could slow sales and development activity for the remainder of the year.

In Singapore, demand for residential space appears to have had a bit of a resurgence in the second quarter. Although rents versus the first quarter were flat, demand was particularly strong for detached houses and large apartment units in new buildings at the high end of the luxury segment. Property values increased only marginally, leaving yields essentially unchanged compared with 1Q05. The stable price of investment-grade properties and their relatively limited supply has made them an attractive opportunity for foreign investors.

Government policies in Singapore implemented just after the close of the quarter should further spur investment, particularly in the luxury segment. In July, the government raised the bank lending limit on property purchases from 80% to 90% of the price, permitted pension funds to buy property with 30- to 60-year leases, lowered the required cash payment by private buyers from 10% to 5% and permitted foreign investors to own property in apartment blocks of less than seven floors.

Although the South Korean government has implemented a series of policies to slow speculation, much like China has done, the residential market remained active in the first six months of 2005. In Seoul, prices rose 4.5% during the quarter, and mortgage volume rose sharply in June, on expectations that residential prices will continue to rise. The government plans to announce additional measures this summer to help stabilize the residential market.

Following a spike in prices, sales of luxury apartments in Bangkok were slow in 2Q05. Although some cooling of sales volume was expected, leasing activity remained high, particularly for new buildings. Rents increased 4.2% from the first quarter to the second. However, rising rents were outpaced by rising values, causing yields to decline slightly during the quarter.

The residential market in Kuala Lumpur appears to be in a recovery stage. Both improved infrastructure and a spate of new products have helped to spur the market. Rents rose only 2.0% versus 1Q05, but property values appreciated 6.0%, causing yields to fall. However, the outlook for residential property for the rest of 2005 is generally positive.

Retail

Domestic demand for goods remained strong during the second quarter as the region's economy grew. The burgeoning middle class still drives the retail market in Asia. As the labor market improves and incomes rise, retail sales should stay strong for the rest of 2005. Retail continues to be the darling of investment in Asia thanks to its stable returns and relatively higher yields.

Demand for retail space in China continues to be strong as retailers seek to tap the huge consumer market. The major obstacle is finding suitable space, particularly for international retailers. An important trend in China is the emergence of the hypermarket, such as Wal-Mart, Carrefour and E-Mart. This retail segment potentially offers a market size in the tens of billions of dollars over the next few years. In Beijing and Shanghai, limited supply and stable demand drove rents up 1.2% and 5.2%, respectively, compared with 1Q05. But property values grew faster than rents during the quarter, leading to a fall in yields on Beijing and Shanghai retail properties.

The Hong Kong retail market appears to be strengthening. Rents rose 4.0% compared with 1Q05 as both central and secondary shopping districts experienced rent increases. The rising rents caused yields to grow during the quarter. Private consumption, spurred by the highest consumer confidence level since 1989, coupled with tourist spending, helped spur the market.

In Singapore, rents escalated during the quarter, particularly in prime retail space in Class-A malls, although the increases were broadly based. Leasing activity is expected to remain strong for the remainder of 2005. Property values climbed during the quarter, resulting in slightly lower yields than in the first quarter. S-REITs made a few notable acquisitions, namely Hougang Plaza, Park Mall and several units of Katong Shopping Center. However, currently only 36% of the retail malls in Singapore (and an even smaller percentage of the total retail space) are held by REITs and property funds. Not all of the retail space available is institutional quality, but these figures highlight the potential investment activity that could still occur.

Industrial

Although the industrial sector is an immature property class in Asia relative to the other three major classes, it is quickly evolving. Because Asia is becoming the main origin of products world-wide, the industrial market, particularly logistics, should benefit. The Asian logistics market is projected to grow at a compound annual rate of 12.6% over the next five to six years.

Consequently, demand for logistics-related real estate should increase accordingly. The structural outsourcing trend of logistics companies, such as Exel, Fedex and Danzas, presents an opportunity for industrial and logistics REITs to expand via acquisition in the region.

Demand for industrial space should remain particularly strong in China due to its place among the largest trading nations in the world. Through the first five months of 2005, China had a $30 billion trade surplus, with exports of $276 billion and imports of $246 billion. Both Beijing and Shanghai experienced an increase in net exports from 2004 levels. Consequently, competition for good sites in these areas is fierce.

Interest in Japanese industrial properties remains high. In addition to the foreign REITs that have been active in purchasing and developing properties, Japan Logistics Fund, Inc., a specialty REIT, was listed in May. This follows from the continuing trend of manufacturing companies leasing, as opposed to owning, their buildings, which is a fairly recent development. As third-party asset management efficiency improves, it should increase opportunities for investment, not only in the remainder of 2005, but thereafter.

To enhance the business environment near Seoul, the government has eased the rules on the development of industrial and cultural facilities in the city's metropolitan area. This is a move away from the prior policy, which sought to stem overcrowding. Beginning next year, companies can construct new factories or expand existing facilities in the Seoul metro area.

Conclusion

Although it now appears that economic growth will be slower in 2005 than in 2004, the outlook for the Asian economy remains positive, maintaining its position as one of the world's growth engines. Although China is clearly the leader (on pace for 9% GDP growth in 2005), the entire region is poised to do well. Even Japan, which has been mired in an economic morass for the last 15 years, is finally displaying some encouraging economic signs.

As the regional economy recovers and fundamentals continue to improve, the outlook for Asian real estate also remains favorable. Stable demand and limited supply will keep office rental rates high across the region as the economy recovers and companies seek new office space. A growing middle class and increasing tourism will fuel demand for retail throughout Asia, particularly in the prime shopping centers. Asia's large population creates a favorable outlook for the residential sector. Although this property class has been the darling of investors recently, and a slowdown is possible, the long-term outlook, particularly with the growing middle class, is optimistic. Asia's status as the world's workshop bodes well for industrial, not only this year, but over the long term. This is particularly true in China, which will continue to be a major player in world trade.

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