Deutsche
Asset Management

Marketing Material

Research Report

Asia Pacific Real Estate Strategic Outlook

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1 Executive Summary

Macroeconomic conditions in Asia Pacific saw a significant recovery in 2017, supported by the stronger-than-expected cyclical upturn in global trade conditions since the latter part of 2016. Meanwhile, job growth in the region continues to hover above historical ten-year averages particularly in Japan and Australia. Despite the tightening in global financial conditions and higher economic growth, monetary policies in Asia remain broadly accommodative underpinned by low inflationary pressures. Nonetheless, risk factors persist ranging from uncertainties surrounding China's growth and economic health, tightening of interest rate policies in major developed nations to global geopolitical risks, which could adversely impact regional trade and export demand. Barring any shocks or unexpected shifts in the baseline, regional economic growth is expected to remain broadly stable at 5.5% in 2018[1].

Real estate performance across much of the Asia Pacific region remains healthy on the back of strong capital markets and stable occupier fundamentals. Across the region, key cities in Japan, China, Hong Kong and Australia continued to see healthy office leasing demand in 2017, while the weight of capital targeting quality assets have contributed to further cap rate compression in core markets. The regional markets in Japan with healthy fundamentals appear increasingly attractive from a risk-return perspective to rationalize as part of a core strategy portfolio.

The outlook of property returns which have been heavily front loaded in our previous forecast could flatten over our forecast horizon through 2022. Total returns in the coming years are likely to be driven mostly by income yields with capital growth likely capped by yield expansion driven by increasing prospects of higher interest rates. Nevertheless, in our view, Asia Pacific commercial real estate markets are expected to deliver healthy core unlevered total returns ranging between 5.9% - 7.4% per annum over the next five years with industrial returns outperforming office and retail returns[2,3].

Asia Pacific Real Estate target markets:

	Theme	Sector	Countries/Cities	Main Rationale
Core Strategy[3]	Core Locations with Strong Fundamentals	Office	Sydney, Melbourne and Osaka	Further rental upside potential with stable occupier demand outpacing limited supply in the next couple of years.
		High street retail/Suburban/ Neighbourhood centres	Sydney, Melbourne and Osaka	Limited supply across major high street retail. Suburban/neighbourhood centres provide cushion against fluctuations in discretionary spending.
	High Yields Underpinned by Stable Cash Flows	Logistics	Japan, South Korea, Singapore, Australia	High income yields and stable rental growth underpinned by favourable demographic dynamics and rising e-commerce retail trends.
	Cyclical Uplift in Recovery Markets	Office	Singapore	Rents poised for a cyclical recovery as leasing sentiment improves coupled with diminished supply pressures over next few years.
			Brisbane	Rents approaching cyclical trough and receding office supply to lift pressure from vacancy rates.
	Mid-Term Opportunities	Office/Retail	Tokyo, Seoul	Selective approach with near-term returns in Central Tokyo capped by tough competition from local J-REITs. Subdued office demand in Seoul with limited rental growth till 2019.
	Regional Markets	Office/High street retail/Suburban centres/Logistics	Regional cities in Japan	Attractive excess returns over risk free rate with historical low vacancy rates and borrowing costs.
Core Plus and Value Added Strategy[3]	Theme	Sector	Countries/Cities	Main Rationale
	Active Asset Management	Office	Japan, South Korea, Australia, Shanghai, Beijing	Utilize asset management specialty and local knowledge to enhance asset performance and improve cash flows of older but well-located assets.
		High street retail/Shopping centres	Japan, South Korea, Australia, Shanghai, Beijing	Improvement of foot traffic and reposition tenant mix for underperforming high street retail and shopping centres.
	Forward Commitments	Office/Retail/Logistics /Hotel	Japan, South Korea and Australia	Potential for higher returns compared to investments in core stabilized assets.

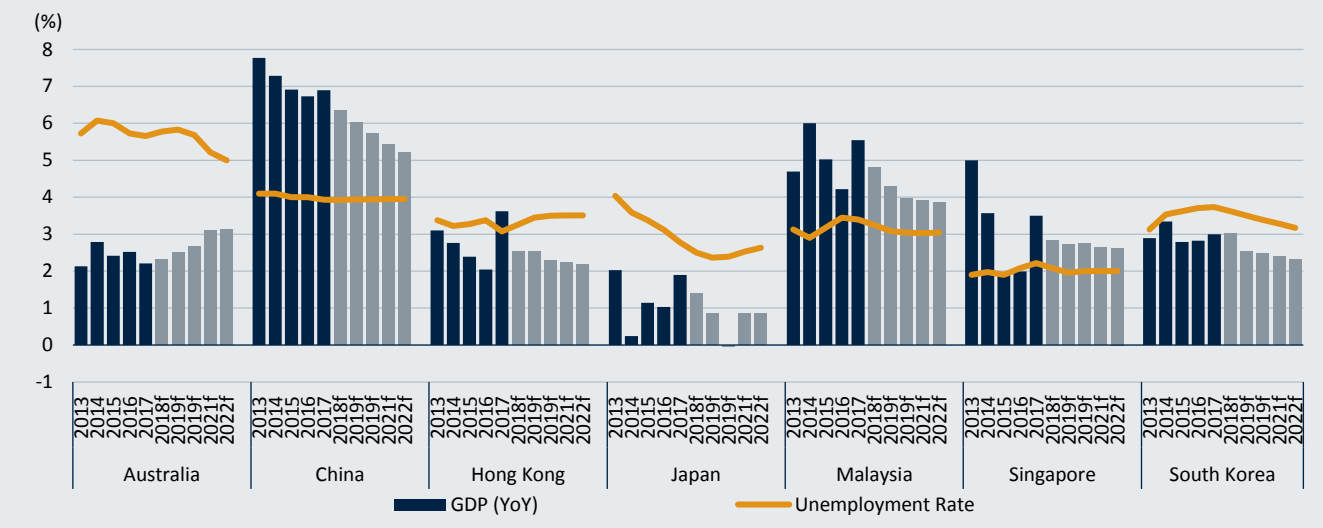
[1] IMF Regional Economic Outlook: Asia Pacific, October 2017.
[2,3] Source: Deutsche Asset Management, as at February 2018.
Note: f = forecast. There is no guarantee the forecasts will materialize.
[3] See chapter 3 for further discussion on Core Strategy and Core Plus and Value Added Strategy.
No assurance can be given that investment objectives will be achieved.

2 The Economy

Economic conditions in Asia Pacific strengthened considerably in 2017, supported by a pickup in global trade combined with a rally in commodity prices and robust domestic demand. China's economy continued to demonstrate signs of stabilization, underpinned by strong infrastructure investment and domestic consumption. Australia's transition towards a more diversified growth led by the non-mining sectors has continued, particularly in the main Eastern states. In Japan and South Korea, export demand has picked up while recovery signs are seen in domestic consumption too.

The region's growth momentum remains partially supported by favourable monetary policies where central banks continue to balance between the risks of high asset prices and the nascent recovery in demand. Nonetheless, geopolitical risks persist ranging from rising anti-globalisation sentiments which could potentially lead to increased protectionism, as well as geopolitical tensions involving the Korean peninsula, which poses risks to the recent global recovery. Barring any unexpected shocks or shifts in the baseline, growth for the region is expected to remain relatively stable at 5.5%[4] in 2018.

Exhibit 1: Asia Pacific Real GDP growth & Unemployment rates



Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As at Feb 2018.
Note: f = forecast. There is no guarantee the forecasts will materialize.

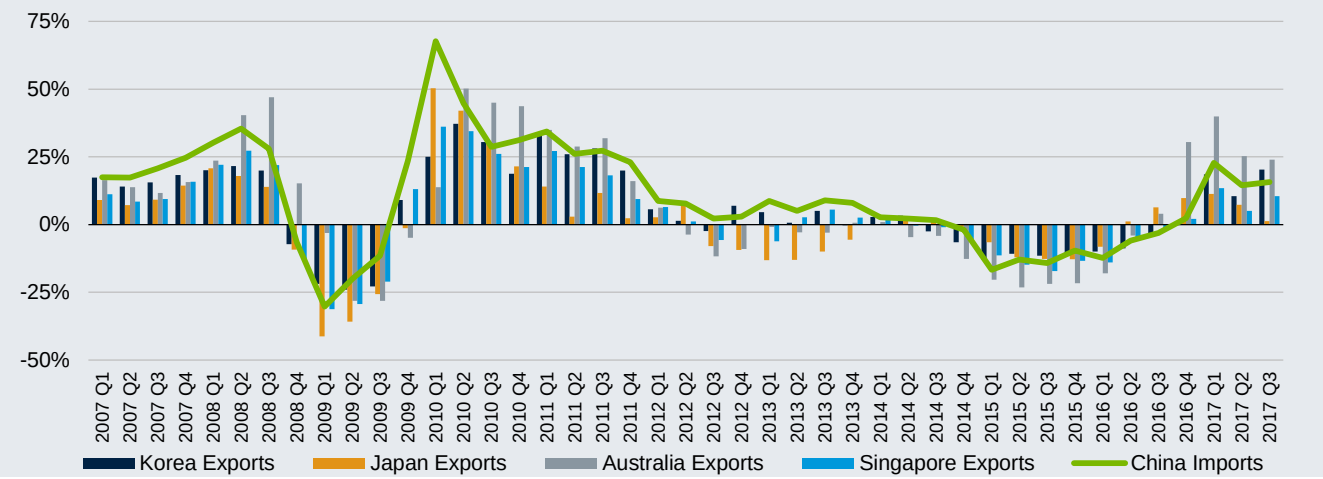
External demand:

The U.S. growth momentum remains strong supported by consumer spending and a steady labor market. Financial markets remain buoyant as the Dow Jones Industrial Average and S&P 500 benchmark indices soared to all-time highs in 2017, fuelled by strong corporate earnings. The Tax Cuts and Jobs Act (TCJA) passed by the U.S. Congress in December 2017 should support personal consumption and provide a further boost to economic growth. Meanwhile, the Euro zone economy appears on course towards a firmer footing notwithstanding the uncertainty and possible ramifications of the Brexit process. Notwithstanding the positive economic backdrop, elevated asset prices and rising expectations of the U.S Federal Reserve stepping up monetary tightening set off a sudden correction in the US and global capital markets in early February, highlighting the susceptibility of investment markets to swings in investor sentiments.

The stronger external environment underpinned export and economic growth across the Asia Pacific economies. China, which constitutes the largest single trading partner for many neighboring countries in the region, had undergone significant structural reforms over the past few years. Since 2011, the resulting pullback in import demand from the world's second largest economy ran in parallel with declining trade volumes in the region. Regional trade growth saw a turning point towards the second half of 2016 with a broad-based recovery in exports in many major countries including Japan, South Korea, Australia and Singapore, as well as the United States and Europe.

[4] IMF Regional Economic Outlook: Asia Pacific, October 2017.

Exhibit 2: Growth in Asia's exports and China's imports (y-o-y %)

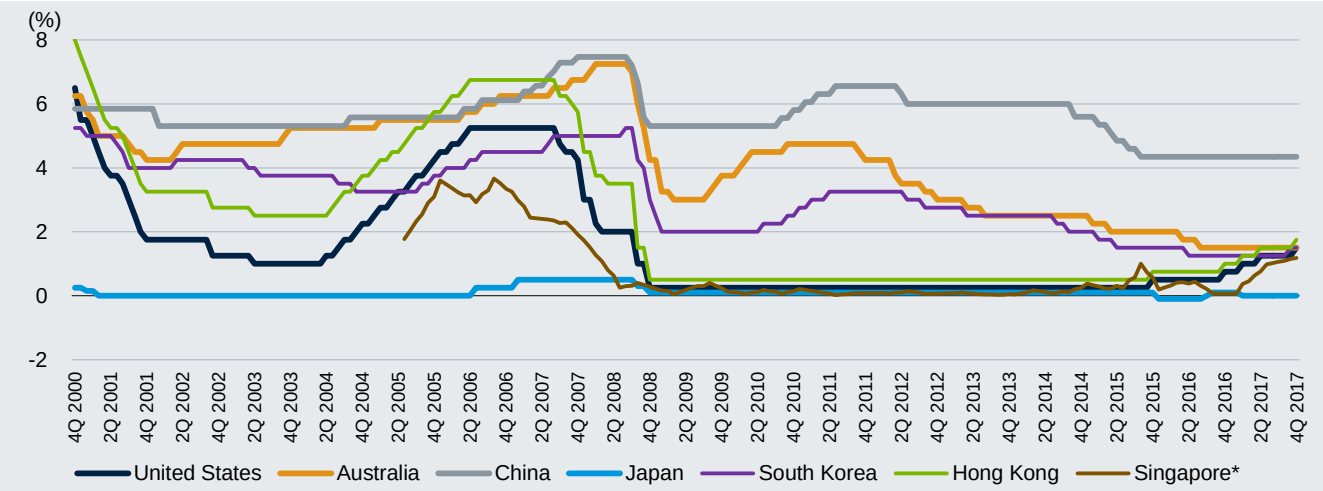


Source: Deutsche Asset Management, Oxford Economics. As at Feb 2018.

Monetary policy:

Despite gradual interest rate hikes and the tapering of quantitative easing in the western countries, major central banks in Asia Pacific have kept monetary policies accommodative in 2017 in support of domestic demand. The Bank of Japan (BoJ), Reserve Bank of Australia (RBA) and the People's Bank of China (PBoC) maintained their domestic policy rates at all-time lows in attempts to stimulate their respective economies. On the other hand, The Bank of Korea and Hong Kong Monetary Authority raised interest rates in 2017, while borrowing costs in Singapore had also increased following the U.S. rate hikes in the year. Going forward, while central banks in the region are expected to remain supportive in favour of growth, a stronger U.S. and global economy would likely propel global interest rates higher, exerting upward pressures on policy rates in Asia Pacific to bridge the differential with global interest rates and prevent excessive capital outflows into other regions.

Exhibit 3: Policy rates in major Asia Pacific economies



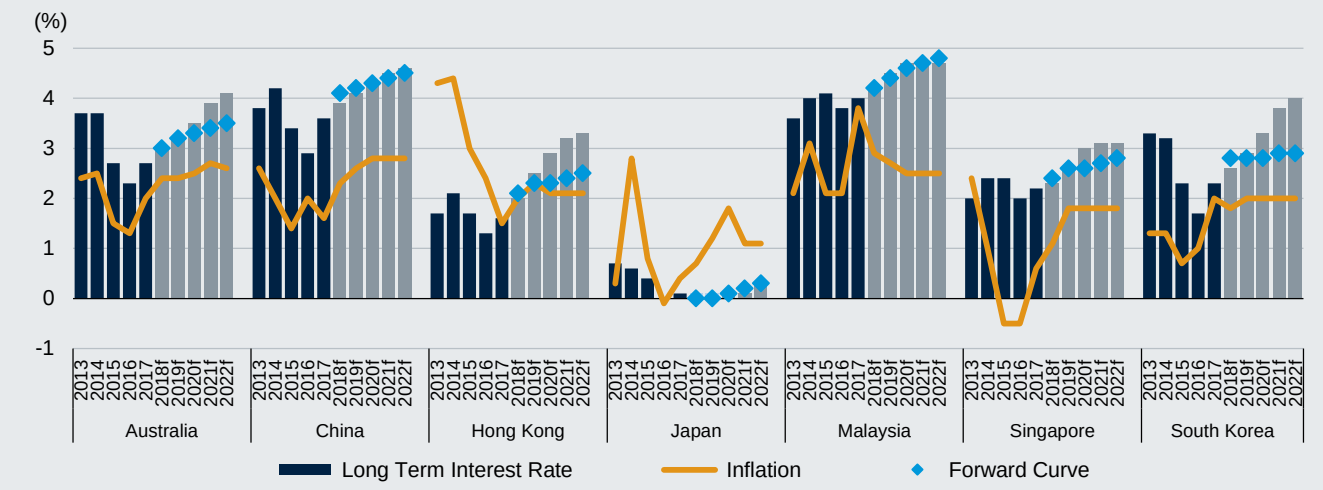
Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As at Feb 2018.
*Based on the Singapore domestic interbank overnight rate.

Inflation:

Inflationary pressures have largely remained stable across Asia Pacific, especially in the major economies of China, Japan, South Korea and Australia, though inflation is expected to pick up in later years on the back of improving demand and consumption. Through 2017, average ten-year government bond yields have risen by some 10 – 90 basis points in the region, with the highest increases in Hong Kong and China. Ten year bond yields are generally expected to rise across the region, albeit at varying degrees, between 25 to 100 basis points over the next five years. Deutsche Asset Management (Deutsche AM) anticipates a risk of cap rate increase in some markets, especially in the trade dependant economies of Hong Kong and Singapore. (Our view is in line with the interest rate level anticipated in the forward market).[5]

[5] Bloomberg. Data as at January 30, 2017.

Exhibit 4: Inflation & long-term interest rates



Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As at Feb 2018.
Note: f = forecast. There is no guarantee the forecasts will materialize.

2.1 Economic Outlook

— Japan: Japan's GDP growth is forecast to be 1.4% in 2018 on the back of the strong corporate sector. The recovery in private consumption contributed to growth, boosted by an historical low unemployment rate and record number of foreign tourist arrivals. The Nikkei 225 index reached 24,000 in January 2018, the highest level in 26 years, signaling strong investment confidence. In contrast to other major central banks considering "Tapering", the Bank of Japan has consistently kept its monetary policy controlling long-term interest rates near 0%. CPI has grown by circa 1% at the end of 2017, and is expected to maintain the same level in 2018.

— South Korea: South Korea's real GDP is forecast to grow by 3.0% in 2018, slightly higher than the average of 2.8% in the last five years. The recovery in 2017 was driven by a double-digit growth in exports, while private consumption is projected to drive growth in 2018. Geopolitical risks over North Korea remain a threat to a further recovery. Bank of Korea raised its benchmark interest rate from 1.25% to 1.5% in November 2017 for the first time in more than six years, prior to the U.S. rate hike in December. The rate hike signaled increased confidence in the economic outlook, while further interest rate hikes in 2018 are also rumored in the market, in order to prevent capital flight and to cool down house prices.

— China: China's economy has demonstrated resilience with strong GDP growth of 6.9% in 2017, though tighter capital controls and ongoing deleveraging should lead to lower growth of 6.5% in 2018. Growth has been underpinned by improving exports, rising housing sales and the construction boom. Household consumption supported by rising incomes remains a key long term driver while fiscal policy will likely remain expansionary, providing some support for infrastructure investment. The tighter government controls over capital outflows since early 2017 are likely to continue to slow down outbound corporate investments, reducing the impact which Chinese investors exert on commercial and residential real estate markets in both Asia Pacific and worldwide.

— South East Asia: Growth in ASEAN economies is expected to remain robust. A recovery in exports is supported by the improving external trade environment, while private investment and consumption remains major drivers of domestic demand supported by long-term structural trends of rising urbanization and household incomes. Notwithstanding, risks abound from volatility in commodity prices and potential capital outflows atop currency weakness triggered by prospects of higher U.S. interest rates. Latest projections by IMF[6] forecast GDP growth of 4.9% for the leading ASEAN economies in 2018.

— Singapore: Singapore benefited from strong economic growth of 3.5% in 2017, underpinned by a cyclical recovery in manufacturing output and exports in line with better global economic data. Nonetheless, headwinds remain from the ongoing economic transition and low labour productivity though growth momentum remains in some industries such as the wealth, insurance and healthcare sectors. Domestic interest rates have risen gradually in line with U.S. rate hikes, with the trend likely to continue in the near future.

[6] IMF Regional Economic Outlook: Asia Pacific, October 2017.

— Australia: Australia's economic growth has been supported by investments in the non-mining sectors and a positive contribution from net exports. However, consumer spending has remained subdued given weak wage growth. GDP growth is expected to rise to circa 2.7% from 2018-2022 in line with the pickup in non-mining business investments as well as an increase in LNG exports and ongoing growth in services exports including tourism and education. The RBA is expected to keep the cash rate on hold at 1.5% throughout 2018 as weak wage growth and increasing debt levels continue to weigh on household spending. The RBA is anticipated to begin hiking interest rates towards the end of 2019.

2.2 Risks to the Forecast

— Slowdown in China: Risks to the Asia Pacific region center on the outlook for China's growth and the implications for commodity demand. Being the largest trading partner for many APAC nations from natural resources in Australia to intermediate electronic and machinery products of export dependent nations Singapore and South Korea, a sharper-than-expected slowdown in China's economy would see trade flow and economic growth decline in the region. Additionally, high corporate debt levels and increased capital outflows in recent years may lead to a sharper-than-expected tightening of capital controls and credit lending in efforts to rein in rising leverage risks in the financial system, which could negatively impact investment spending and slow down China's economic growth.

— Interest rate volatility and cap rate widening: Prospects of successive rate hikes by the U.S. Fed could affect key REIT markets such as Australia, Japan, Singapore and Hong Kong, which are structurally sensitive to the long term interest rate volatility. These REIT markets could impact the broader direct real estate markets in terms of transaction volume, yields, capital value and more importantly the market sentiment. We have reflected this in our cap rate assumptions in the base case scenarios for each market although risks remain that cap rates might widen more significantly than anticipated.

— Global Geopolitical Risks: Despite increasing domestic consumption, Asia Pacific's economies remain highly dependent on exports trade. Rising anti-globalization sentiments could lead to increasing protectionism policies and higher trade barriers, therefore limiting economic growth and adversely impacting export and trade volumes. Political risks include the impact of Britain's exit from the European Union and the uncertainties on trade policies from the current US administration. Finally, closer to home, geopolitical risks persist such as escalating tensions involving the Korean peninsula which could pose an immediate threat to South Korea on top of disrupting regional economic growth.

— Increased Government Debt levels: High levels of foreign debt were a major contributor leading to the Asian financial crisis in 1997-98. Though many countries in Asia Pacific are now on stronger financial footing, government debt levels have generally increased across the region from 1996 to 2016. As of 2016, the Debt-to-GDP ratio in Japan was 201%, much higher than other APAC countries such as South Korea (38%), Australia (36%) and Singapore (113%)[7]. In Japan, risks from high government debt levels are partly mitigated by the fact that majority of the government debt is domestically held with limited reliance on external borrowings, supported by significant levels of foreign exchange reserves exceeding USD 1.3 trillion, and relatively lower interest rates/expenses relative to GDP despite higher debt levels relative to 20 years ago. Nonetheless, higher debt levels present a potential long-term risk, limiting the flexibility of governments to either adopt expansionary fiscal policies to stimulate economic growth or tighten monetary policies in the event of overheating in their respective domestic economies.

[7] Bank for International Settlements Database, September 2017.

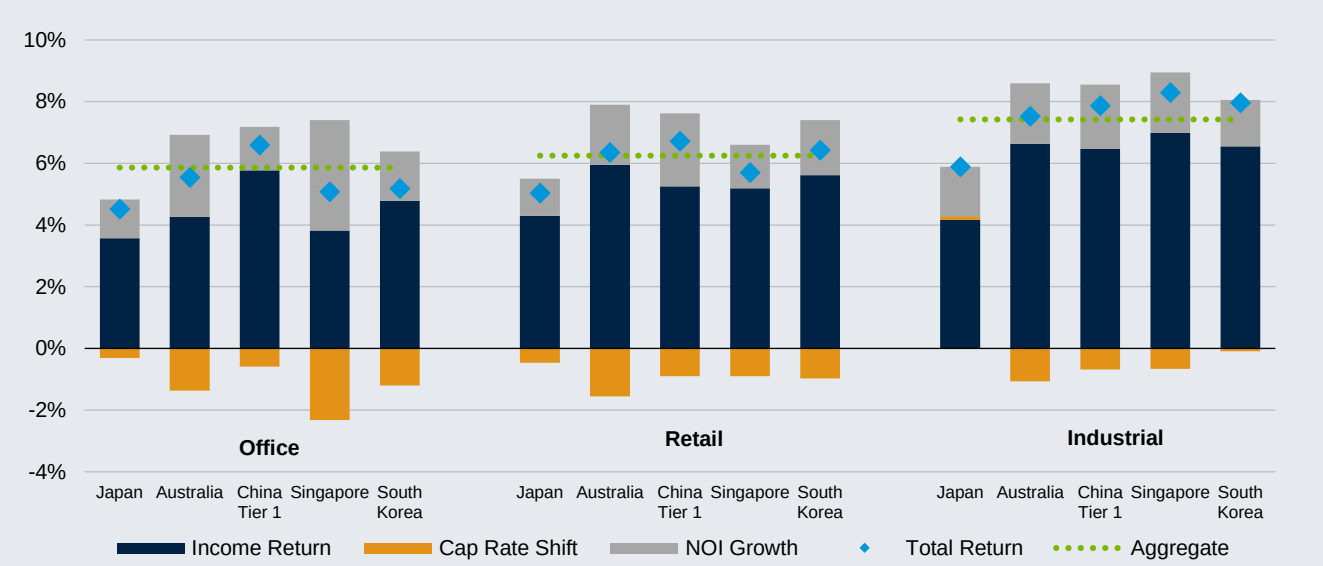
3 Strategic Real Estate Outlook[8]

Real estate performance across much of the Asia Pacific region has been relatively healthy notwithstanding early indications of slowing activity on the back of sustained cap rate compression in key core markets. Sydney and Melbourne led office rental growth in the region, underpinned by stable occupier demand and limited new supply. Leasing activity also remained healthy in key Tier 1 cities in China, driven by domestic financial services and technology firms, as well as in Singapore where rents have shown early signs of recovery following a two-year decline. Vacancy rates in Tokyo and regional cities in Japan continued to fall on the back of healthy occupier demand and controlled supply levels. However, performance in some other markets including Perth and Seoul remain subdued due to either a surge in new supply or weak tenant demand in 2017.

Core unlevered aggregate total returns in the region fell marginally to 7.9% in 2017, lower compared to the 9.4% recorded in 2016 and three-year average of 10% recorded from 2014 to 2016.[9,11] The weight of capital targeting quality assets in the region has contributed to further cap rate compression (albeit less pronounced compared to the earlier years which led to significant capital gains), especially in Japan and Australia where regional cities have experienced cap rate compression trends seen in the key gateway cities. The trend was compounded by active investments from sovereign capital, pension funds and insurance firms, which have increased their real estate allocation. As such, much of the capital growth was front loaded and realized in recent years, leading to diminished prospects of capital growth over coming years in the forecast horizon. We anticipate negative impacts from the possible widening of cap rates in most markets in coming years, albeit offset by positive income growth trends, with future returns likely driven mostly by income yields.

Looking ahead, in terms of sector performance, core unlevered aggregate total returns are expected to range between 5.9% - 7.4%[10] annually over the next five years with the industrial sector likely to yield higher returns compared to office and retail. Near term returns are capped in Tokyo and Seoul given the strong competition for good quality assets and subdued tenant demand, respectively. Nevertheless, potential widening of cap rates in the medium term could create good entry opportunities for investors seeking higher exposure within the region.

Exhibit 5: Projected annual total return by sector and country in Asia Pacific, 2018-2022F



Source: Deutsche Asset Management. As of Feb 2018.
Note: f = forecast. Projected returns are based on compounded basis. There is no guarantee the forecast returns shown will materialize. Country returns are stock-weighted based on city level data[11]. As such, the performance and forecast shown represent hypothetical and simulated performance, which has many inherent limitations. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. No assurance is made that forecast returns will be achieved.

[8] Deutsche Asset Management. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.
[9] Source: Deutsche Asset Management Calculations, Feb 2018.
[10] Source: Deutsche Asset Management Forecasts, Feb 2018.
[11] Japan – Tokyo (All sectors), Osaka/Yokohama/Nagoya (Office); Australia – Sydney/Melbourne (All sectors), Brisbane (Office & Industrial), Perth/Adelaide (Office); China Tier 1 – Beijing/Shanghai (All sectors), Guangzhou (Office & Retail); South Korea – Seoul.

3.1 Strategic Investment Themes

Since summer 2016, we have witnessed further tightening of cap rates in Japan, Australia and South Korea in line with historically low interest rates while cap rates remained tight in Singapore and Hong Kong. It has become increasingly challenging for investors seeking income producing core-type opportunities in these markets to achieve their target returns, with some opting to move up the risk curve and/or diversify their target sectors. Notably, in spite of the cap rate compression trends, spreads to long-term bond yields across most of the Asia Pacific markets remain relatively comfortable above their long-term averages, providing investors some buffer in the event of rising domestic bond yields in future.

We continue to hold the view that while part of the cap rate compression was driven by anticipation of a recovering rental cycle, other structural factors were also at play: (1) geographical diversification needs as evident from the gradual increase in cross-border transactions, and (2) continuous amount of capital available for real estate investments with an estimated US$28 billion[12] of dry powder available through Asia-focused closed-end private real estate funds, an increase from US$23 billion as at the end of 2016.

We favour markets with relatively good yield spreads to mitigate risks arising from potential widening of cap rates, and healthy leasing fundamentals to provide rental income growth to drive returns going forward. While investors are likely to retain interest in core gateway cities with good fundamentals, elevated asset prices in these locations have enhanced the appeal of quality assets in secondary locations and regional cities. As such we expect to see increasing investment activities into the secondary markets as investors seek higher-yielding assets to fulfill their returns requirements.

Core Strategy:

— Core Locations with Strong Fundamentals: Good income producing assets providing meaningful returns in key gateway cities, i.e. Osaka, Sydney and Melbourne, have continued to attract global capital. Although forward returns are projected to moderate vis-à-vis the strong outperformance achieved in the past twelve months, this strategy continues to offer investors the potential for further income growth with stable corporate occupier demand outpacing limited supply. High street retail in major shopping destinations with access to high footfall as well as suburban or neighbourhood retail centres with large catchments in Osaka, Sydney and Melbourne also remains attractive. Supply is tight across major high street locations while suburban neighborhood centres provide a cushion against fluctuations in discretionary spending.

— High Yields Underpinned by Stable Cashflows: For investors looking for higher income returns, attractive opportunities persist in the logistics sector given the steady income stream nature underpinned by favourable demographic dynamics and ongoing proliferation of online retail, and higher yields of logistics properties – typically in excess of 6% (4% for greater Tokyo).[13] Target markets which appear attractive include prime logistics centres in key transportation hubs including Japan, Korea, Singapore and Australia.

— Cyclical Uplift in Recovery Markets: For investors willing to look beyond the current low rental trends, markets poised for a near-term recovery offer an attractive combination of higher entry yields and potential for market-driven returns. We see opportunities in the office markets in Singapore, where rentals are in early stages of recovery following improved leasing sentiments and lower supply pressures, and in Brisbane with improved occupier demand supported by low development pipeline and shortage of Grade A space.

— Mid-term Opportunities: Monitor progress and look out for optimal entry timing in core investable markets with near-term returns capped by intense competition for assets with domestic REITs i.e. Central Tokyo or facing short-term vacancy issues i.e. Seoul. Despite current weak rental prospects at the latter markets, demand supply dynamics are expected to improve gradually in favour of landlords on the back of recovering occupier demand leading to cyclical rental uplifts in later years.

— Regional Markets with Good Fundamentals and attractive excess returns: The ten-year Japan government bond yield remains near zero levels and borrowing costs are extremely cheap. Vacancy rates have declined close to historical lows in major Japanese regional cities. These markets are expected to yield some of the best excess returns over the risk free rate, indicating good investment returns with local financing secured.

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[12] Preqin Quarterly Update: Real Estate, Q3 2017, Oct 2017.
Deutsche Asset Management. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.
[13] Source: Deutsche Asset Management Forecasts, Feb 2018.

Core Plus and Value Added Strategy:

— Active Asset Management: We see opportunities in key cities in mature North Asian and Australian markets by taking on leasing risks for vacant office properties or refurbishment/re-positioning of older but well-located properties. High street and shopping centres are also strong candidates for a value-add proposition including improvements in retail footfall and repositioning of tenant mix. In China, opportunities could arise from repositioning underperforming office assets and improving tenant mix for retail assets in prime locations such as Beijing and Shanghai. Strong local network and deep market knowledge are crucial for successful value enhancement.

— Forward Commitments: In certain markets, entering into joint ventures with strong local operating partners for forward commitments provides a viable route to access good real estate assets with the potential for enhanced returns compared to investments in core stabilized assets. We see selective opportunities in commercial sectors including the hotel, office and logistics sectors in Japan, South Korea and Australia. Construction risk and lease-up risk are key considerations that can be mitigated through partnerships with reputable local operators and leasing agents.

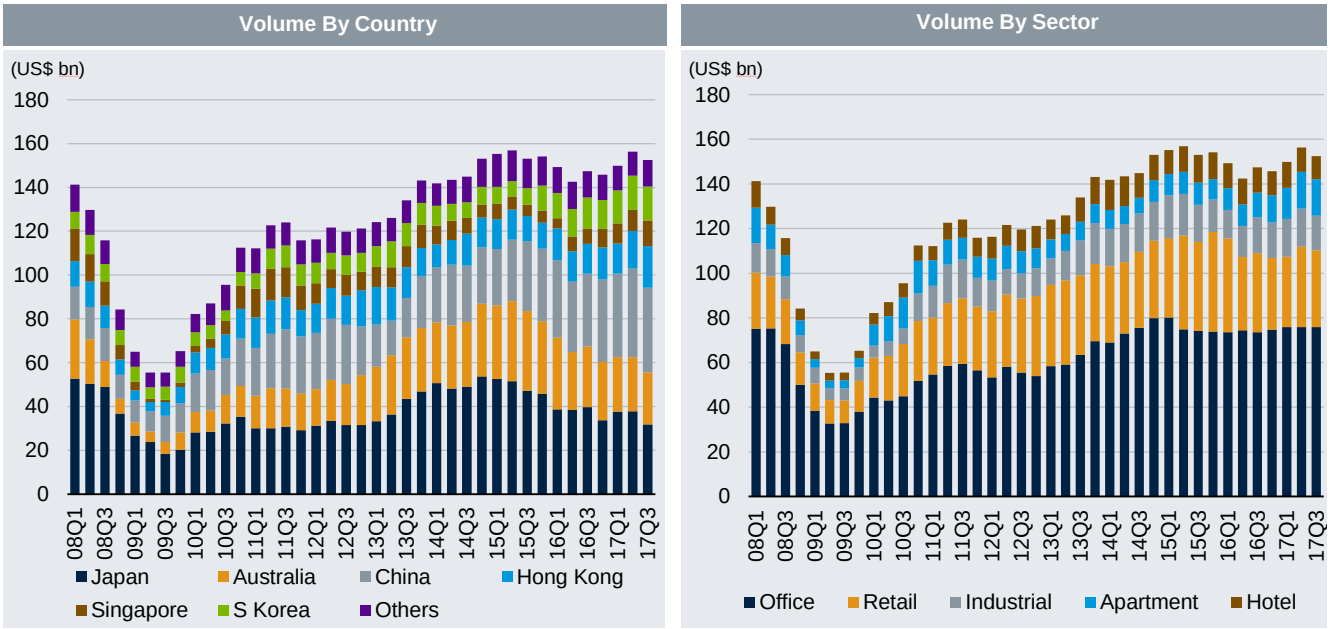
3.2 Capital Markets

Transactions:

Data from Real Capital Analytics showed that commercial real estate transaction activity in Asia Pacific remained robust in 2017, with transaction volumes (excl. land) in the 12-month period to the second quarter of 2017 reaching US$156 billion, just shy of the US$157 billion peak achieved in the second quarter of 2015. This was notwithstanding tighter yields and higher asset prices increasingly stretched by continued investor appetite, particularly in the main cities in Japan and Australia.

As at the third quarter of 2017, 12-month transaction volumes in the region rose 3.4% year-on-year. Volumes in Australia and Japan fell 14% and 20% respectively, though offset by increased investments in China (+16%), Singapore (+68%), South Korea (+10%) and Hong Kong (+39%). During the same period, China attracted the largest share of real estate investments in Asia Pacific, accounting for 25% of total transaction volume, followed closely by Japan (21%) and Australia (16%). Office investments accounted for the majority or 50% of total transaction volumes, followed by retail investments (23%).

Exhibit 6: Asia Pacific transaction volume (rolling 12-month)



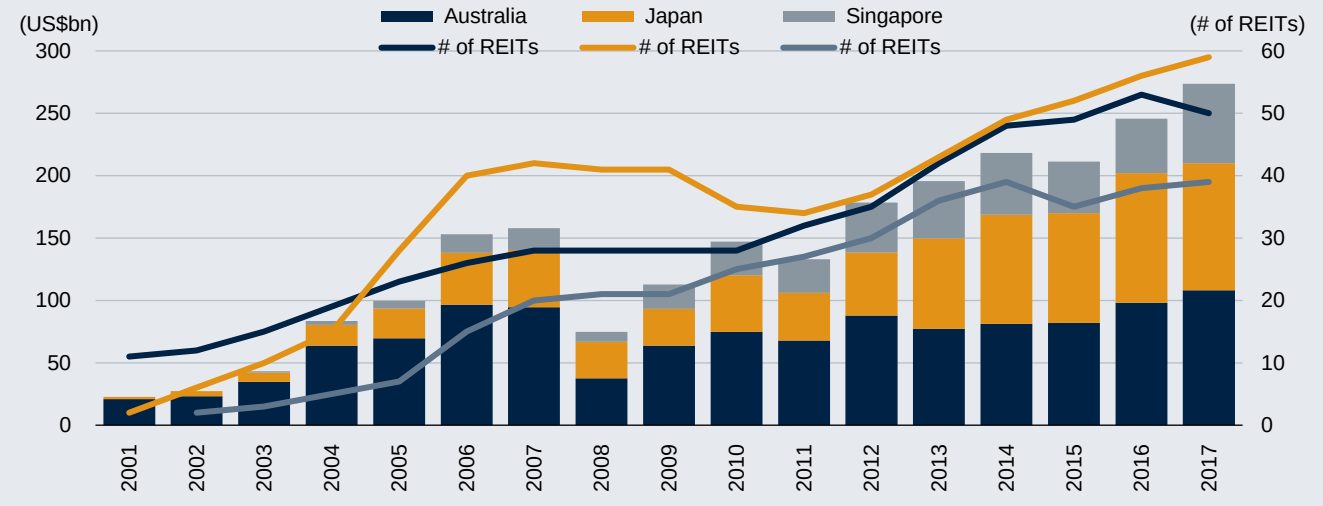
Data shown based on rolling 12-month period.

Source: Deutsche Asset Management, Real Capital Analytics. As of Feb 2018. Past performance is not indicative of future returns.
Note: Figures exclude land acquisitions.

REITs:

The REIT market in developed Asia Pacific is gradually approaching maturity since the initial stages of development at the start of the millennium. Despite facing higher prospects of rising interest rates, overall performance in the sector remained generally healthy, with Asia Pacific REITs delivering gross total returns of 13.2% (in USD terms) in 2017[14], relatively stable compared to a year ago. Notwithstanding, performance across the major markets was mixed, with Japan REITs underperforming due to capital outflows from REIT mutual funds as a result of tighter regulatory requirements. On the other hand, REITs in Singapore and Hong Kong saw substantial price gains, reflecting increasing optimism over the outlook of the physical real estate market coupled with favourable price to current book values, while prices of Australian REITs remained relatively flat.

Exhibit 7: Market Capitalization of listed REITs in Asia Pacific

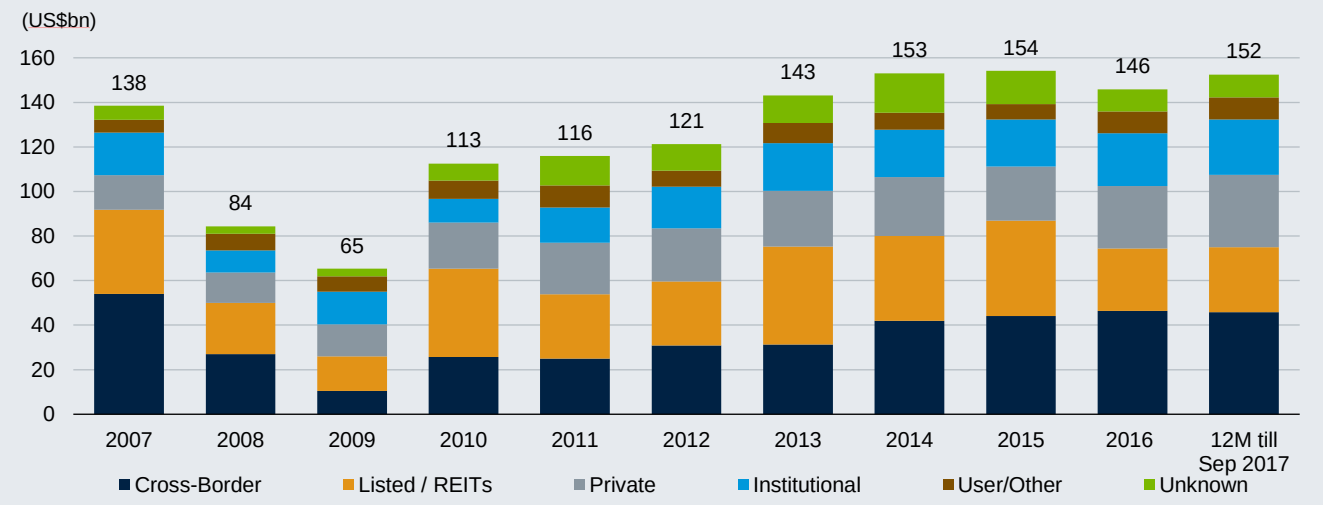


Source: Deutsche Asset Management, Bloomberg. As at Feb 2018.

Investor Profile:

Cross-border investors remain active in the region, accounting for 30% of transaction volume in Asia Pacific in 2017, relatively unchanged compared to 32% in 2016. A number of high profile multi-billion dollar transactions by foreign investors were observed in the region, including Seoul, Singapore and Shanghai while overseas capital accounted for between 40-45% of investments in Sydney, Melbourne and Singapore. Listed corporations and REITs form the next largest buyer group in the region, accounting for 22% of transaction volumes, relatively unchanged from the 20% share in 2016, followed closely by private investors (21%).

Exhibit 8: Asia Pacific investor profile



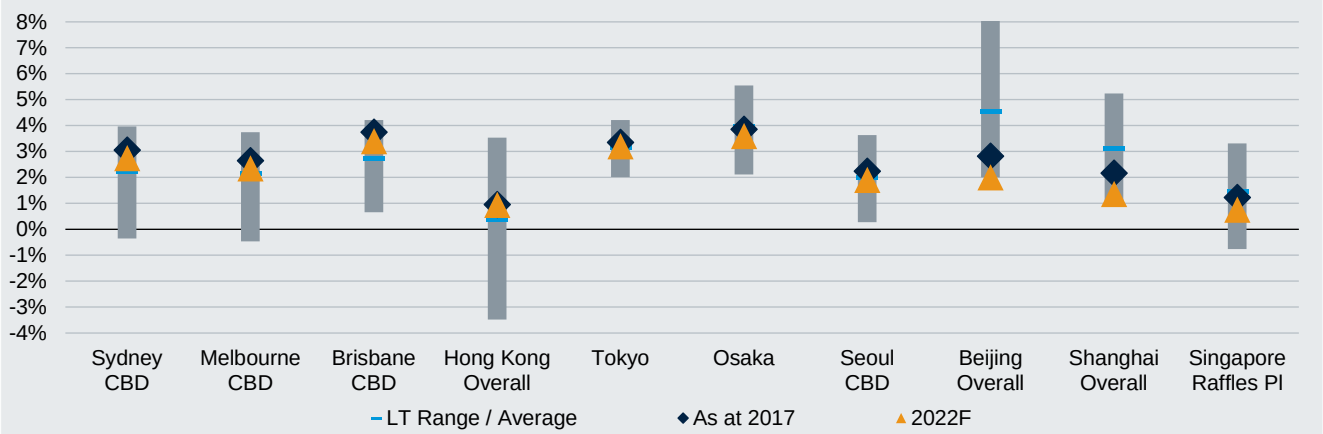
Source: Deutsche Asset Management, Real Capital Analytics. As of Feb 2018.
Note: f = forecast. There is no guarantee the forecast returns shown will materialize. Figures exclude land acquisitions and developments.

[14] MSCI AC Asia Pacific REITS Index, as of 29 Dec 2017.

Office:

The trend of global and domestic capital chasing income producing office assets has contributed to cap rate compressions in 2017 in the majority of countries across the region including Japan, South Korea, Singapore and Australia, while cap rates remain broadly flat in other markets such as China and Hong Kong, in line with interest rate movements. The tight conditions were supported by active investments by sovereign capital, pension funds, insurance firms and cross border investors chasing large deals while activity softened at domestic REITs in Japan amid a moderate correction at the listed REIT market. Cap rates are expected to undergo marginal expansion over the next few years in line with rising interest rates, with the smaller economies of Singapore and Hong Kong more susceptible to rising yields.

Exhibit 9: Office sector: Cap rate spreads to 10Y government bond yield



Source: Deutsche Asset Management, Colliers, Oxford Economics, Bloomberg. As of Feb 2018.
Note: f = forecast. There is no guarantee the forecast returns shown will materialize. LT denotes period of past 20 years or shorter where data is available.

Retail:

Sizable institutional grade assets in the retail sector remain tightly held by local developers and REITs in markets like Hong Kong, Singapore and Australia, capping deal volumes. High street retail sales benefited from increasing tourist arrivals in Japan and Australia, while private wealth capital is more dominant in transactions in prime high street areas in Hong Kong, Shanghai, Tokyo Ginza and Seoul Gangnam where cap rates remain extremely tight. Institutional investors have been observed to be exploring suburban assets in Japan, Australia and to a lesser degree in South Korea, where investors and REITs have tried to reshuffle existing portfolios.

Industrial:

Investor interest in the industrial and logistics sector remains strong due to the relatively higher yields and the recent evolution and gradual maturity of the sector, though acquisition opportunities of institutional grade assets remain limited. The supply of modern facilities is catching up to increasing demand with multiple large assets currently in the development pipeline in major metros in Japan, South Korea and China in 2018 and beyond. Further yield compression (albeit marginal) could occur in Japan, while yields have stabilized in other markets.

Exhibit 10: Retail sector: Cap rate spreads to 10Y bond yield

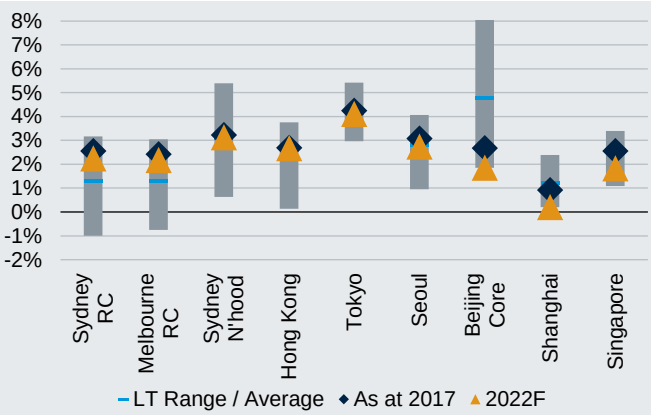
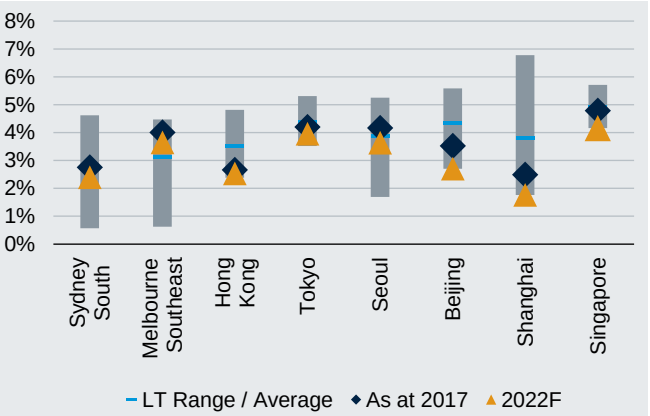


Exhibit 11: Industrial sector: Cap rate spreads to 10Y bond yield



Source: Deutsche Asset Management, Colliers, JREI, CBRE, Oxford Economics, Bloomberg. As of Feb 2018.
Note: f = forecast. There is no guarantee the forecast returns shown will materialize. LT denotes period of past 20 years or shorter where data is available.

Credit markets:

The financing environment remains largely positive due to the favorable monetary policy and supportive measures. Notwithstanding, compared to six months ago, base reference rates have moved up marginally by 10-40 basis points in Hong Kong, South Korea and Singapore, while remaining relatively stable in Australia, Japan and China. Meanwhile, spreads remained largely unchanged at similar levels. With the exception of China and Hong Kong, office cap rate spreads over financing costs remain positive across core markets with the highest positive carry of circa 200-300 basis points in the Australia and Japan markets.

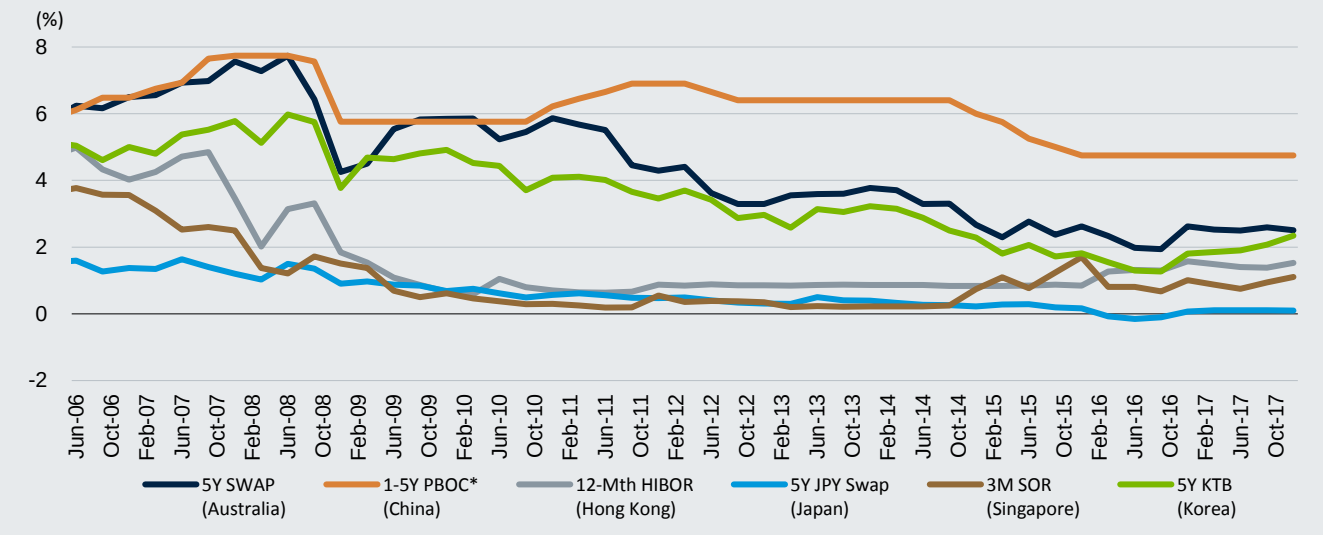
Nonetheless, there are signs that lenders are becoming sensitive to high valuations especially for assets with weaker leasing covenants or in inferior locations. This could potentially lead to moderate cap rate widening from 2018 onwards.

Exhibit 12: Typical commercial lending terms

Market	LTV (%)	Base Reference rate	Spread (bps)	Financing Cost (bps)
Australia	50%	5Y Swap Rate : 2.50%	150 - 170	400 - 420
China	50-60%	1-5 year base lending: 4.75%	300 - 500	775 - 975
Hong Kong	50%	1 year HIBOR: 1.55%	200 - 300	355 – 455
Japan	50%	5Y JPY swap rate + TL spread: 0.2%	40 - 60	60 – 80
Singapore	60%	3M Swap Offer Rate: 1.15%	120 - 180	235 – 295
South Korea	50-60%	5Y KTB: 2.35%	140 - 180	375 – 415

Source: Deutsche Asset Management, Bloomberg. As at Feb 2018.
For illustrative purposes only.

Exhibit 13: Typical base reference rates for commercial lending



Source: Deutsche Asset Management, Bloomberg. As at Feb 2018.
* Figures before Dec 2014 refer to the 1-3 year PBOC rate.

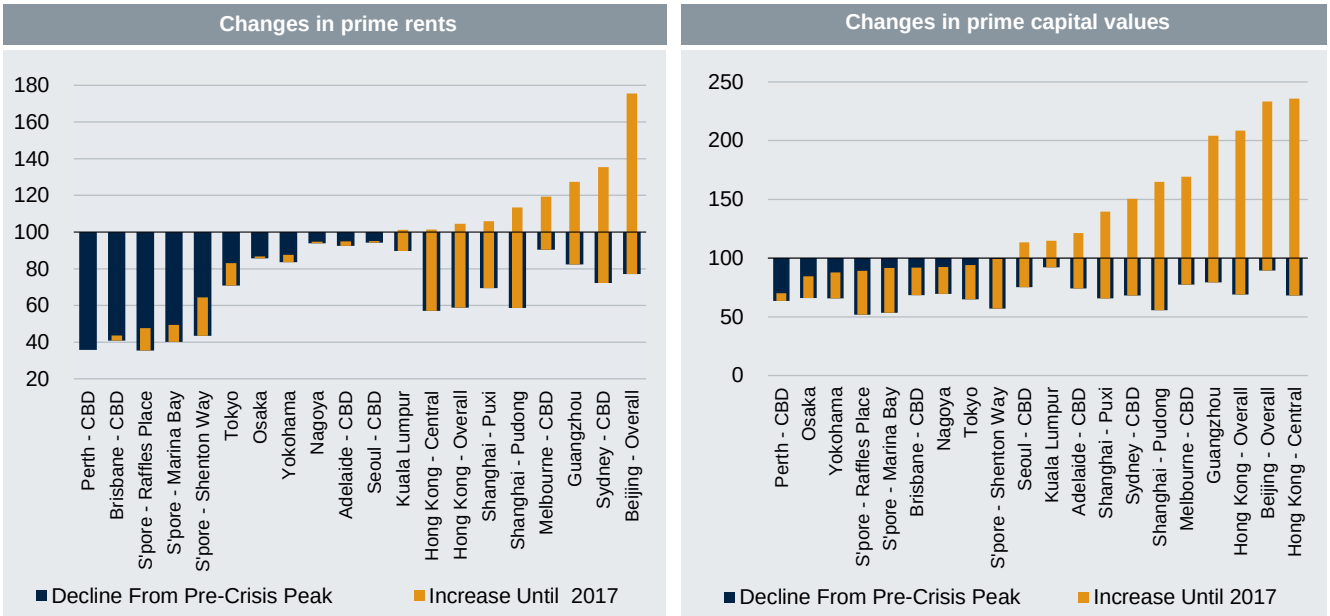
4 Property Sectors and Returns[15]

4.1 Office

Current Conditions: Office markets in core cities across Asia Pacific continued to perform relatively well in 2017, underpinned by steady occupier demand trends. Sydney and Melbourne led the region in effective rental growth driven by a broad base recovery in tenant demand led by business services, followed by Singapore which experienced a strong rental recovery towards the end of the year. Rents in Hong Kong Central were supported by occupier demand from mainland Chinese financial services firms, and in Tokyo rental growth was supported by tight vacancy levels. At the other end, rents in markets such as Seoul and Kuala Lumpur remain in cyclical downturn weighed down by subdued demand and significant short-term supply pressures. While rents in some Australian cities (Brisbane, Perth, Adelaide) have similarly declined over the same period although early signs of stabilization have appeared especially in Brisbane with rents firming in recent quarters.

Looking back a decade since the global financial crisis, office rents in most cities across the region have recovered significantly from the lows in recent years. Falling interest rates contributed to the ongoing yield compression and growth in asset values which led to the significant outperformance of capital value growth to date compared to rental growth in the past decade.

Exhibit 14: Office sector: Decline and recovery in prime rents and capital values (Last peak = 100)



Source: Deutsche Asset Management, Miki Shoji, Colliers. As at Feb 2018.
Note: Last peak between 2007-2008; Trough between 2008-2017.

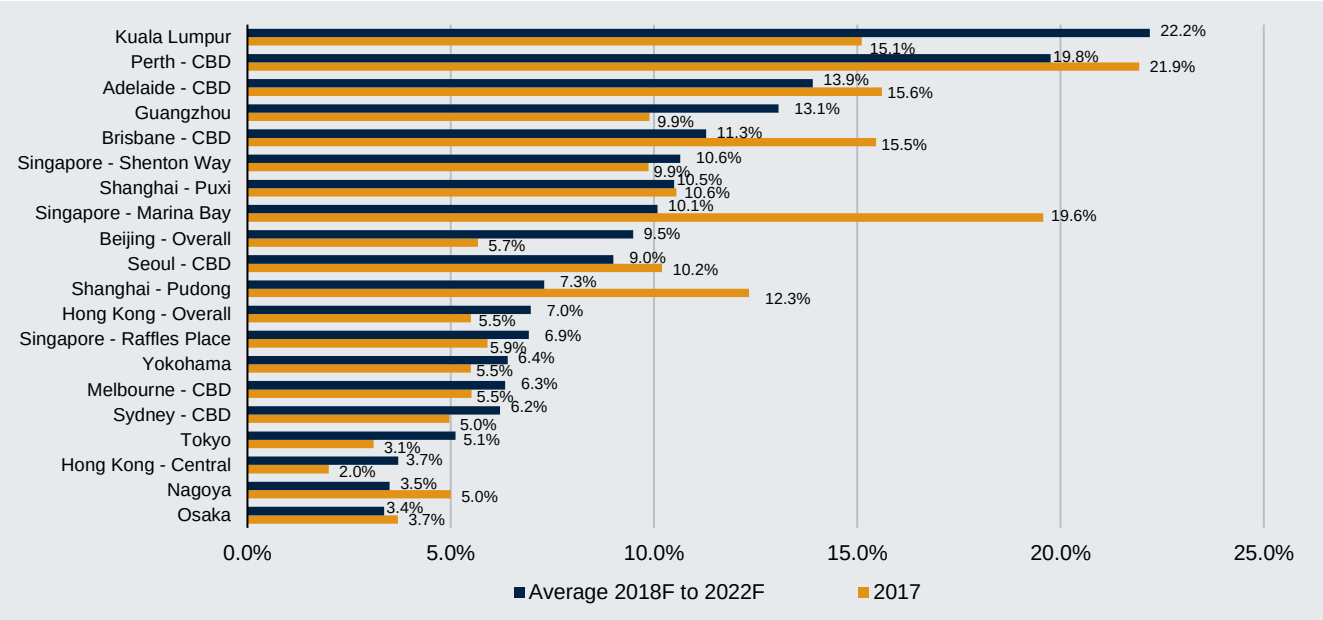
From an occupier perspective, structural shifts in office demand have also been observed in the region, underpinned by the increasing usage of technology-related applications, rising number of millennials in the workforce, and changing conceptualization of the typical workplace environment. Technology firms ranging from Facebook, Apple and Google to smaller technology start-ups have been increasingly taking up office spaces in the CBD at the same time when major financial institutions remain largely in consolidation mode with the exception of growing niche sectors such as Fintech or wealth management activities.

Co-working operators have been expanding rapidly in Asia Pacific, with the larger established operators increasingly venturing from secondary locations or lower-grade offices to higher specification offices in core locations. Notably, while the market share of space leased by these firms remains relatively small and hinges on the sustainability of demand from end-users (i.e. start-ups, small business owners and corporations looking at flexible working arrangements), the segment's rapid growth and increasing trends of collaboration opportunities with office landlords should have a positive impact on the leasing market over time.

[15] Deutsche Asset Management. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.

Outlook: The regional outlook for the office sector remains broadly positive with a reacceleration in economic activity and favorable demand-supply dynamics for most of the key office markets. For the five year forecast period till 2022, vacancy rates in key office markets in Japan and Australia, Hong Kong Central and Seoul are expected to remain relatively stable or improve from current levels. On the other hand, while short-term vacancy pressures currently persist in the Australian regional cities of Brisbane, Adelaide and Perth, occupancy levels are forecast to improve gradually on the back of a recovery in demand, particularly in Brisbane. Singapore, which experienced a supply surge in 2017, is expected to benefit from a strong cyclical recovery as supply pressures subside significantly. On the other hand, vacancy levels are projected to increase in Kuala Lumpur, Beijing and Guangzhou where large development pipelines are underway.

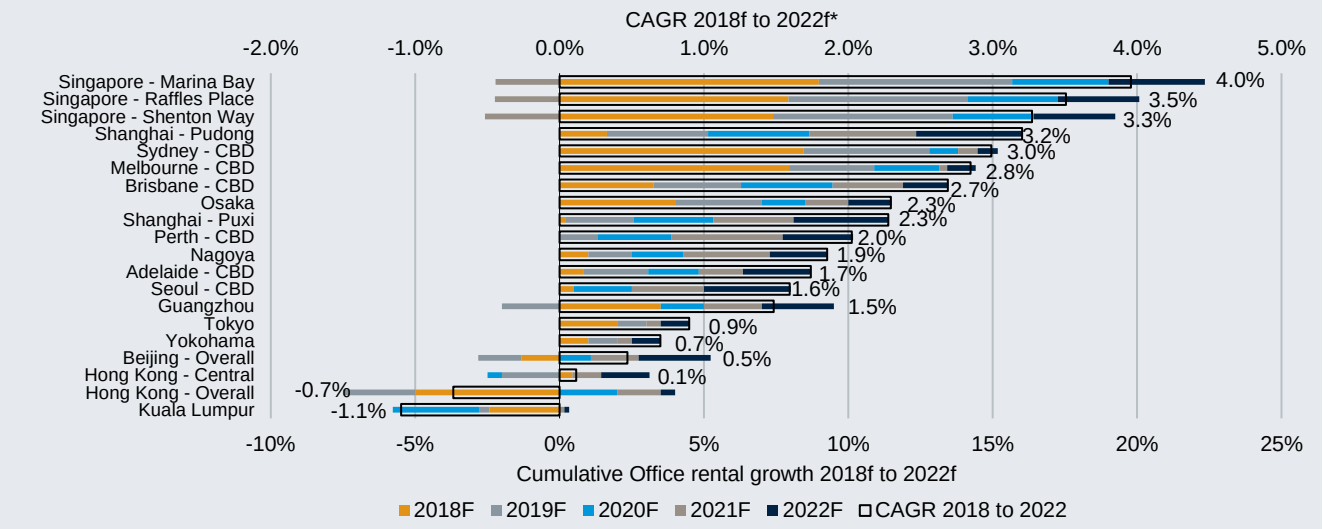
Exhibit 15: Office sector: Projected vacancy rate in selected markets between 2018f – 2022f



Source: Deutsche Asset Management, Miki Shoji, Colliers. As of Feb 2018.
Note: f = forecast. There is no guarantee the forecasts will materialize.

Correspondingly, we expect a divergence in rental growth trends across the region. Over the five-year forecast period, we expect to see the highest rental growth momentum in Singapore underpinned by a cyclical demand recovery combined with limited supply. Robust growth is also expected in the core cities of Australia, while healthy but more moderate growth is expected in Seoul and the Japanese cities with strong corporate demand. At the other end, short-term rental declines are expected in Hong Kong, and other cities such as Adelaide and Kuala Lumpur due to incoming supply pressures, subdued demand or decentralization movements.

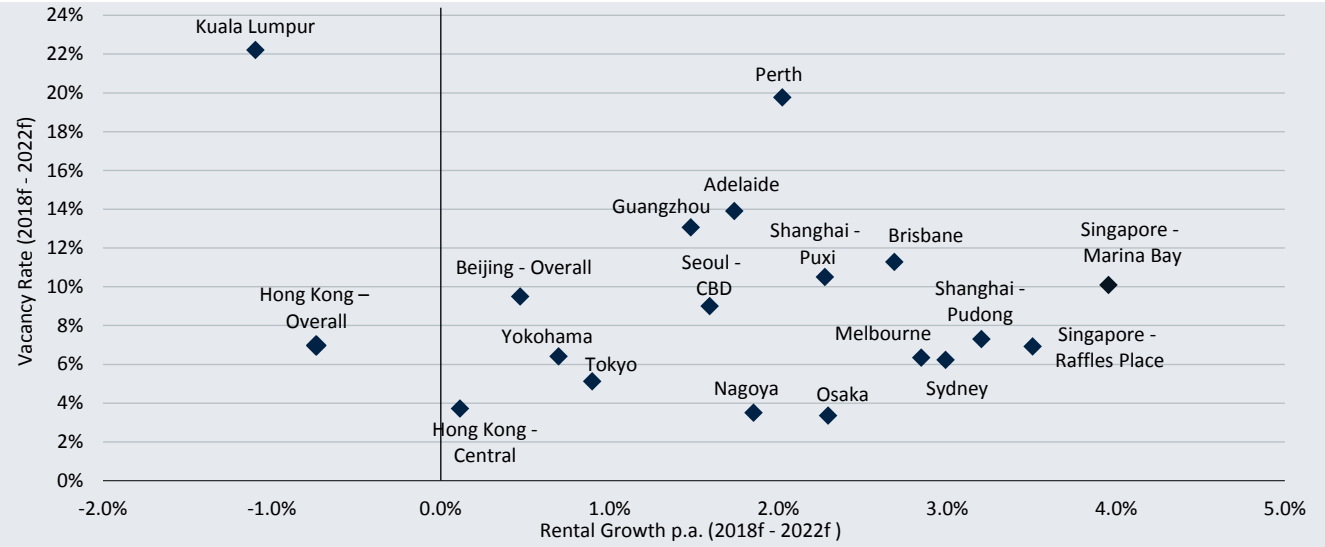
Exhibit 16: Office sector: Projected rental growth between 2018f – 2022f



Source: Deutsche Asset Management. As of Feb 2018.
Note: f = forecast. * Projected returns are based on compounded basis. There is no guarantee the forecasts will materialize.

Combining our rental growth and vacancy projections, we expect improving occupancy levels to underpin moderate to strong rental growth in the eastern seaboard cities in Australia, Singapore, Shanghai, Seoul, and the cities of Osaka and Nagoya in Japan. Markets with projected high vacancy levels such as Perth, Adelaide and Guangzhou over the five year forecast period should see a more modest rental growth profile with further downside risks should demand pan out to be weaker than expected. On the other hand, rents in Kuala Lumpur are curtailed by significant oversupply issues, while growth in Hong Kong (overall) is also projected to be negative due to competition from the incoming supply in decentralized areas.

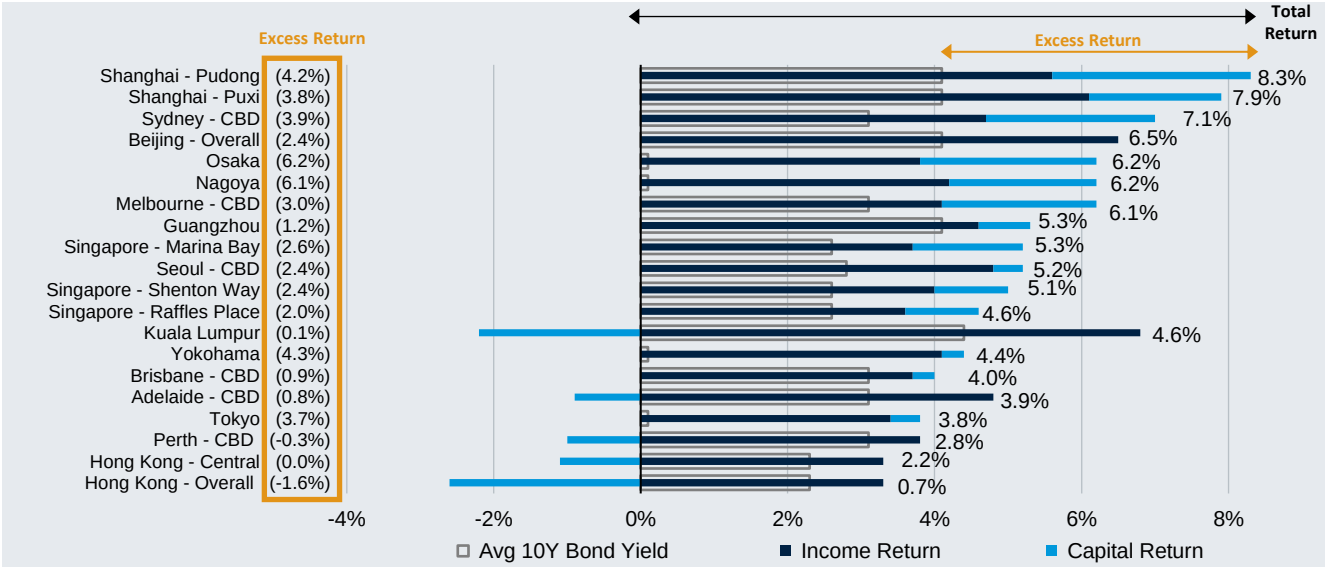
Exhibit 17: Office sector: Projected vacancy rate vs rental growth between 2018f - 2022f



Source: Deutsche Asset Management. As of Feb 2018.
Note: f = forecast. There is no guarantee the forecasts will materialize.

Performance: The APAC office sector is projected to yield mid to high single digit annual total returns in most cities over the next five years through 2022, on the back of healthy demand and moderate supply. Top tier cities in China and Australia are projected to be among the top performers, followed by regional cities in Japan which are expected to provide good excess returns over the local risk free rate, with enhanced investment returns when local financing is secured. Good opportunities are also appearing for investors willing to ride on the current cyclical rental recovery in Singapore, while offices in Seoul are projected to yield moderate returns underpinned by decent income yields. On the other hand, returns in Tokyo should be more subdued due to the current tight cap rates, while forecast five-year performance in Hong Kong is also projected to be relatively weak.

Exhibit 18: Office sector: Projected compounded annual return and excess return between 2018f – 2022f



Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As of Feb 2018.
Note: f = forecast. Projected returns are based on compounded basis. There is no guarantee the forecasts will materialize. Excess return is calculated from income return plus capital appreciation over the local 10 year sovereign bond rate.

4.2 Retail

Current conditions: The rise in e-commerce remains a major driver in redefining the retail landscape in Asia Pacific. Multi-channel or 'Omni-channel' retailing as well as the emergence of mobile-based transactions have seen retailers changing their retail operating models and increasing the selection of goods and services available online often at lower prices than in-store. As a result, this could undermine profit margins for physical retail stores and consequently turnover rent leases at retail centres. Notwithstanding, anecdotal evidence have also showed that some pure play e-commerce companies are merging their online and high street presence by venturing into bricks and mortar store operations for brand building as well as for showroom display.

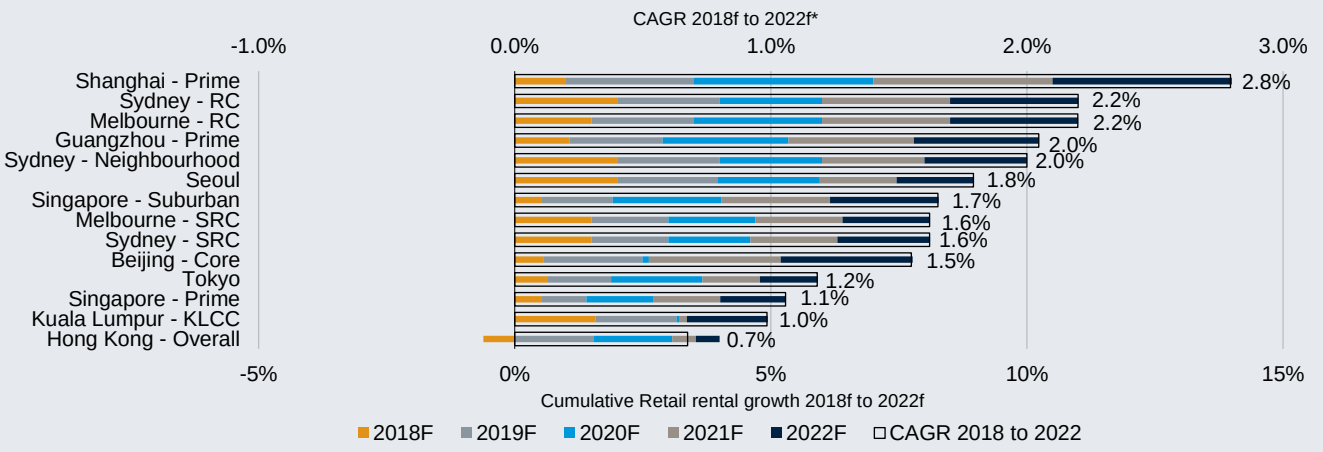
Data from eMarketer[16] indicates the e-commerce market in Asia Pacific grew strongly at 31% in 2017, far outpacing the 7.7% growth in total retail sales in the region. These trends were most notably observed in China, the largest e-commerce market in the world, which accounts for 83% of the online retail sales in Asia Pacific. The share of e-commerce sales as a proportion of total retail sales in China had grown rapidly from approximately 15% in 2015 to over 23% in 2017. Similarly, online retail sales in South Korea have grown strongly, ahead of the United States where e-commerce accounts for only about 9% of retail sales. E-commerce share levels in Japan and Australia are currently just shy of the United States, but emerging trends such as the entry of Amazon into the Australian market towards end-2017 indicate that the online retail is likely to gain momentum in the region.

Diverging trends have also developed in the retail environment across the region. Retail sales continue to underperform in some major markets in the region including Hong Kong, Singapore and Malaysia due to soft domestic consumption and subdued tourist spending. Rents have declined in Singapore and Hong Kong, as retailers face margin pressures from weaker retail spending as well as increasing labour costs.

On the other hand, key cities in China, Australia, South Korea and Japan continue to see healthy, moderate rental growth underpinned by resilient domestic consumption trends or strong tourist arrivals, despite competition from the ongoing proliferation of online retail. Nonetheless, structural shifts in consumer shopping behavior continue to exert pressures on retailers to divert resources from traditional bricks-and-mortar sales building up Omni-channel marketing strategies. As a result, the retail environment remains in favour of tenants as landlords are increasingly forced to offer better incentives especially in the discretionary retail space. Vacancy rates could start to inch upwards in decentralized areas on the back of growing supply while occupier demand from retailers are likely to remain stable in the majority of locations in 2018.

Outlook: Over the five-year forecast horizon, Shanghai and Australian top cities are expected to experience the strongest growth in retail rents in the region, although growth should be more moderate in sub regional centers (SRC) in Australia, where demand could be adversely affected by e-commerce and a slowdown in the housing market. In Seoul and Tokyo, retail rental growth is likely to be modest below 2% per annum, broadly in line with inflation expectations. Near-term rental growth is projected to be minimal in Hong Kong, Singapore and Kuala Lumpur with rents affected by diminished tourist spending.

Exhibit 19: Retail sector: Projected rental growth between 2018f – 2022f



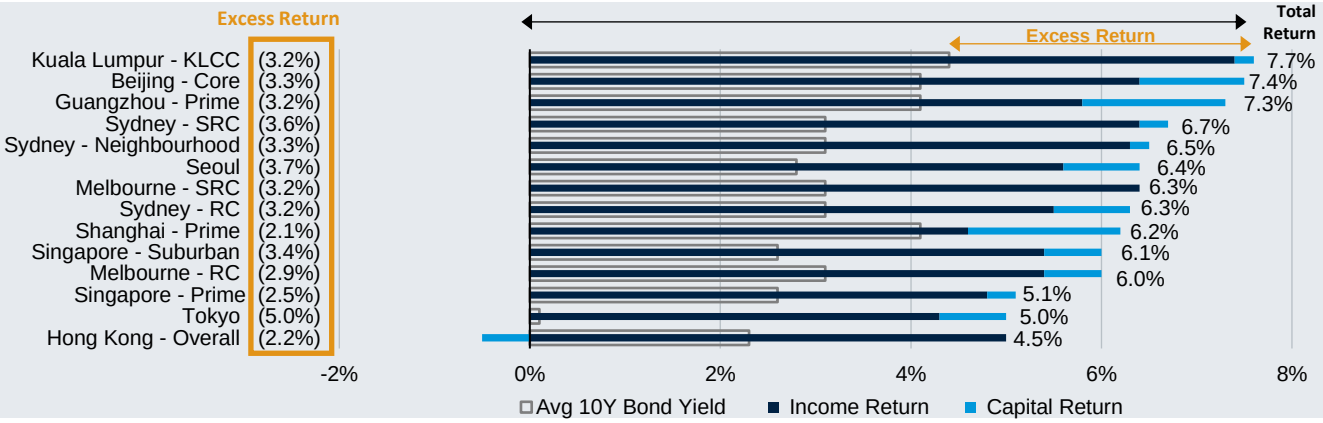
Source: Deutsche Asset Management. As of Feb 2018.
Note: f = forecast. RC= Regional Centres SRC= Sub-regional centres. * Projected returns are based on compounded basis. There is no guarantee the forecasts will materialize.

[16] eMarketer – Asia-Pacific Retail and Ecommerce Sales, January 2018.

Performance: Given the emergence of online retailing, there is a preference among investors toward long term leases in the retail sector. The impact from online retail is expected to be felt more keenly in the discretionary retail segments such as apparel and electronics, compared to the non-discretionary segments such as staple food and daily necessities. Correspondingly, the divergence trends across different retail assets is likely to intensify with a "winner-takes-all" outcome, as well-located malls with strong positioning and good tenant mix continue to command premium rents while poorly-managed malls with weak or unclear positioning may be forced to reduce rents or explore significant repositioning or exit strategies.

Looking ahead, retail assets in China and Australia appear attractive underpinned by higher income yields. While Tokyo looks attractive with the highest projected excess returns (i.e. annual total returns minus bond yields), healthy spreads of circa 2%-4% are expected in most other key retail markets in the region.

Exhibit 20: Retail sector: Projected compounded annual return and excess return between 2018f – 2022f



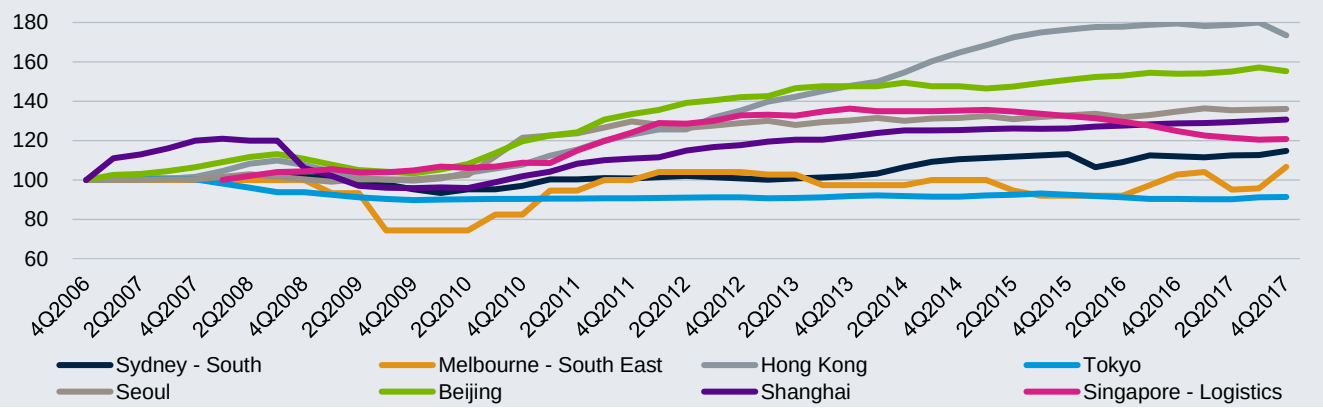
Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As of Feb 2018.
Projected compounded basis. Note: f = forecast RC= Regional Centres SRC= Sub-regional centres. There is no guarantee the forecasts will materialize. Excess return is calculated from income return plus capital appreciation over the local 10 year sovereign bond rate.

4.3 Industrial

Current Conditions: Despite the slowdown in China, prime logistics space across the region continues to see healthy take-up driven by e-commerce and third party logistics providers, resulting in positive rental growth trends across the region. The availability of prime development land and quality modern warehousing facilities is critical for logistics markets undergoing modernization changes coupled with rising domestic consumption, particularly for locations such as Seoul and tier-one cities in China.

The rise of e-commerce trends is also gradually taking place in Southeast Asia, driven by the region's rapidly rising middle class population and consumption trends. Amazon established its foray into the Singapore market in the second half of 2017 with the launch of Amazon Prime Now served by the largest Amazon fulfillment centre in the world, and it also entered the Australian market in late 2017.This followed Alibaba's own expansion through several acquisitions of local and regional e-commerce players operating within and outside China, outlining the increasing growth potential of online retail and needs for logistics spaces in the region.

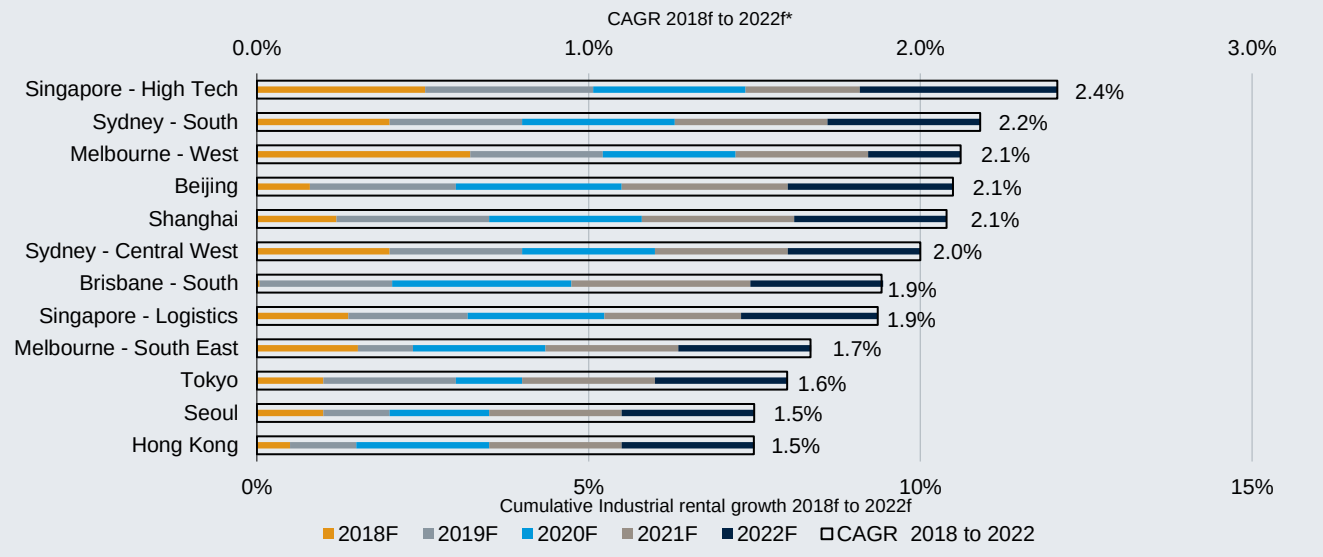
Exhibit 21: Industrial sector: Net rent index (Base Year 4Q2006 = 100)



Source: Deutsche Asset Management, Ichigo, Colliers. As of Feb 2018.

Outlook: In the industrial sector, e-commerce and third party logistics (3PL) companies are expected to remain major leasing demand drivers in the modern logistic space across the region, underpinned by rising e-commerce trends as described in the retail section. Rental growth is expected to be moderate in the region at around 1.5-2.5% per annum, broadly in line with inflation trends as tenants, 3PL companies, retailers and consigners remain mindful of logistics costs.

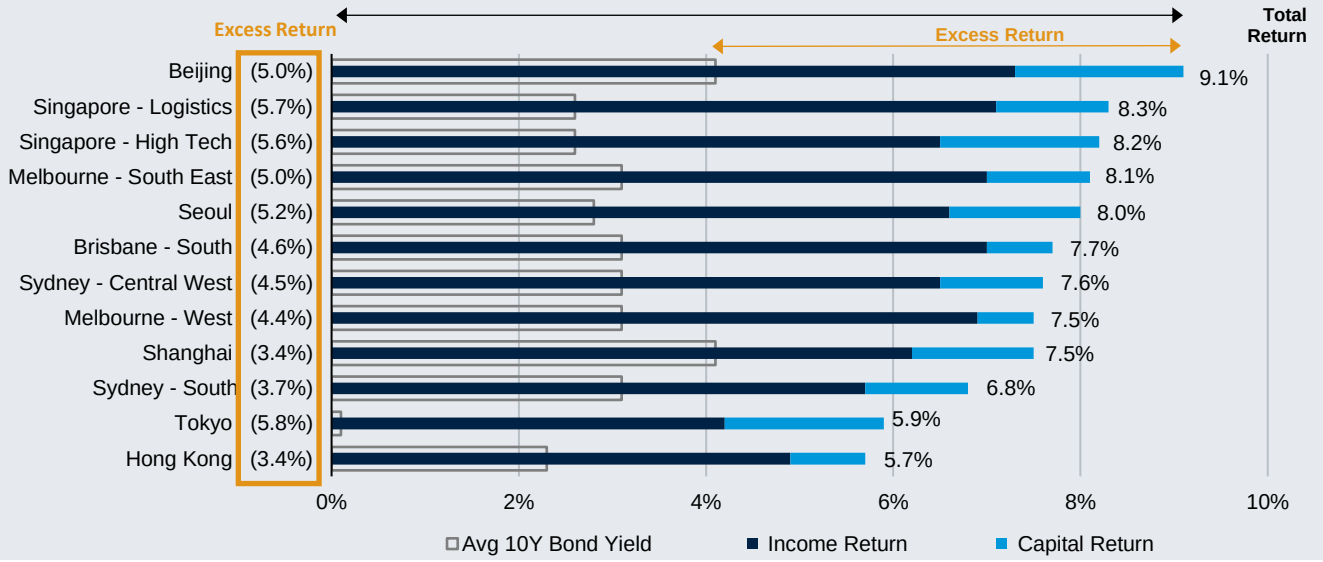
Exhibit 22: Industrial sector: Projected rental growth between 2018f – 2022f



Source: Deutsche Asset Management. As at Feb 2018.
Note f = forecast. There is no guarantee the forecasts will materialize
* Projected returns are based on compounded basis.

Performance: Owing to higher yields, increased transparency and strong underlying occupier demand, the industrial sector has provided consistently higher returns than the office and retail sectors, and is expected to remain attractive in the next five years (see Exhibit 5 on page 8). Five-year return forecasts for the key cities in Australia, China, Singapore and Seoul look favourable at high levels in excess of 7%, though investors could find themselves constrained by the limited deal flow of high quality completed assets in most of these markets. While total returns in Tokyo look to be one of the lowest in the comparison group, excess returns could turn out to be the highest on the back of expected low bond yields.

Exhibit 23: Industrial sector: Projected compounded annual return and excess return between 2018f – 2022f



Source: Deutsche Asset Management, Oxford Economics, Bloomberg. As at Feb 2018.
Projected compounded basis. Note: f = forecast. There is no guarantee the forecasts will materialize. Excess return is calculated from income return plus capital appreciation over the local 10 year sovereign bond rate.

5 Property Risks (office sector)

It is insufficient to compare property-level total returns on a stand-alone basis without factoring the associated risks, especially in the Asia Pacific region where a significant divergence in market maturity and transparency persists. Several factors were considered in the computation of associated risks related to each submarket such as volatility, liquidity, transparency and the effect of obsolescence, along with the domestic risk free rates. The associated risks were formulated using a combination of quantitative and qualitative modeling which have been integrated in our House View.

Exhibit 24 highlights the positioning of the various markets in reference to this framework. The total forecast returns on the vertical axis are plotted against associated risks on the horizontal axis for each office market. Returns are based on the same office sector forecasts outlined on Exhibit 18. A Market Neutral zone (shaded) is added to indicate the level of attractiveness of each market from a risk-return perspective (cities above this line are deemed more attractive and vice versa). We categorize the major office markets into the following 3 groups:

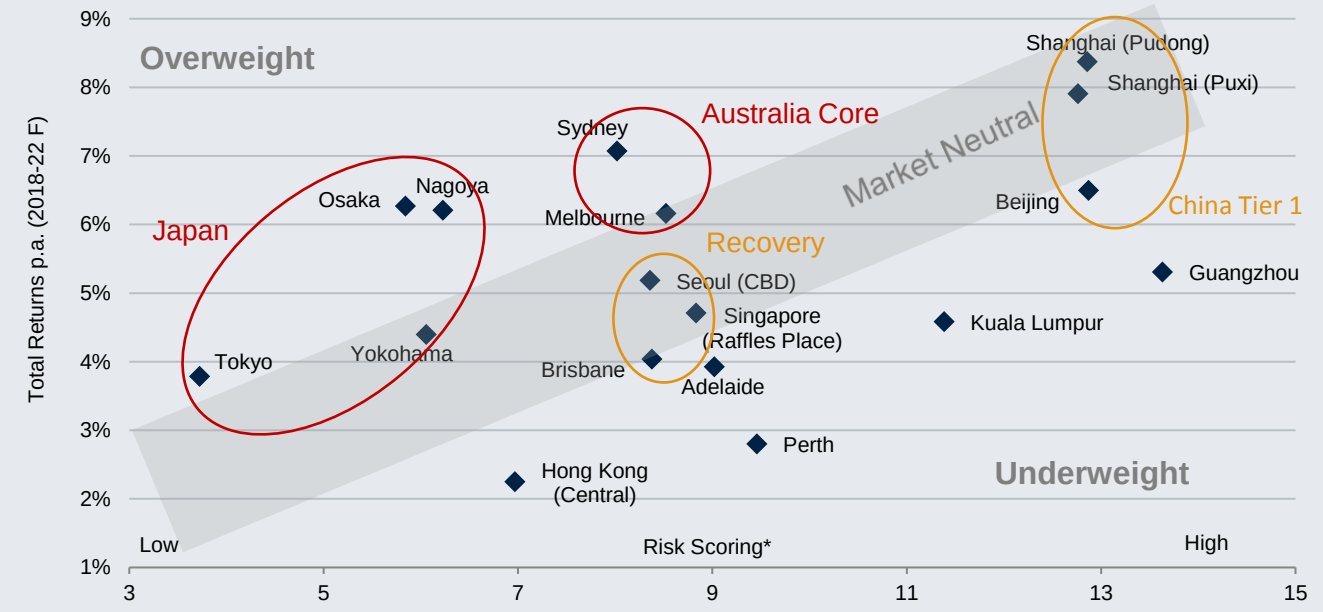
— Overweight: The core target markets include major cities in Japan and Australia where total return forecasts look favorable compared to their associated risks. These are among the most established and mature markets in the region and core investors focused on income yields should center their portfolio investments mainly in these markets. This is broadly in line with the Core Strategy in the Strategic Investment Themes outlined on page 9.

— Market Neutral: Markets with a lower but nonetheless favourable risk-return profile. This includes Tokyo where lower returns are balanced with lower associated risks, and other cities currently either in the mid-late cycle downturn or early stages of market rental recovery such as Seoul, Singapore and Brisbane. A cyclical market recovery is expected in the mid-term as demand-supply fundamentals improve. These are similar to the "Mid-Term Opportunities" and "Recovery Markets" in Strategic Investment Themes outlined on page 9.

  On the other hand, while top tier markets in China are expected to provide higher returns in the next five years, the associated risks are higher partly due to the high risk free rate as well as lower market transparency and other investment hurdles. These markets should be more suitable for value added strategies in line with "Active Asset Management" in Strategic Investment Themes on page 9.

— Underweight: Markets where forecast returns lag associated risks on the back of low forecast returns, high risks or a combination of both. Perth and Kuala Lumpur are examples where demand-supply fundamentals remain largely in favour of tenants at the expense of office landlords.

Exhibit 24: Forecast Returns vs Associated Risks in APAC Office Market:



Source: Deutsche Asset Management, Oxford Economics, Colliers, CBRE, Cushman & Wakefield, Real Capital Analytics. As at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.
Risk Scoring*: A greater risk score indicates higher levels of risks associated with each market. A range of risk factors were considered including the local risk-free rate, historical volatility of returns, level of market liquidity, real estate transparency level and capital expenditure requirements.

Despite favourable performance expectations in some markets there are other challenges and constraints that should be factored for commercial real estate investments which cannot be fully captured in the risk scoring computations, especially for cross border investors.

Currency hedging costs remain relatively expensive in Australia and South Korea for Euro-denominated investors and this can be an impediment for cross border investors when competing with domestic investors, despite favourable returns projections. In Japan, local investors and developers command the upper hand due to extremely cheap borrowing costs in the local debt market, whereas access to cheap capital is limited for foreign investors.

Foreign investors also face additional regulatory and compliance risks compared to domestic investors. In China, onshore holding structures with equity investments from foreign parties require the formation of foreign-invested enterprises (FIEs) or wholly owned foreign enterprises (WOFEs). Conversion of structures is required if the existing holding structure is not in either of these forms and is subjected to regulatory approval, which introduces regulatory uncertainties. Foreign investors also have to deal with the complexities of capital controls and taxation issues which pose considerable challenges to new foreign investors.

Therefore, it is critical for investors to find capable investment managers who have a good foothold in each of these markets when making investments.

6 Overview of Key Asia Pacific Markets

Strategic Outlook: Japan

- Japan GDP growth is forecast to be 1.4% in 2018 off the back of a strong corporate sector. The recovery in private consumption contributed to growth, boosted by the historically low unemployment rate and record number of foreign tourist arrivals.
- In contrast to other major central banks considering "Tapering", Bank of Japan has consistently kept its monetary policy controlling long-term interest rates near 0%. CPI grew by circa 1% at the end of 2017, and similar growth is expected in 2018.
- The office leasing market remains healthy as strong demand and limited future supply kept the office vacancy rates in major cities tighter, while high street retails and hotels enjoyed high turnover underpinned by a record number of tourist arrivals to Japan.
- Despite a strong appetite for further investment, limited deal flows in traditional core locations forced investors to chase more opportunities in regional cities or non-core spaces. The previously dominant J-REITs pulled back from investments, though competition for acquisition opportunities remained strong.

Occupier

- With labor markets staying tight, the office vacancy rate in Central Tokyo compressed to 3.1% in December 2017, 50 basis points lower than a year ago. Vacancy rates expected to remain tight till 2018 with a large supply of new office buildings.
- Rental markets remained broadly healthy in the retail sector in Tokyo and Osaka, on the back of healthy growth from inbound tourists and a recovery in private consumption.
- The unprecedented large new supply in the industrial sector exerted upward pressure on vacancy rates especially in Osaka, though demand for good quality assets remains robust.

Investment

- Continued strong investment demand saw office appraisal cap rates in Tokyo decline to 3.5% in the third quarter of 2017, falling circa30 basis points from a year ago.
- On the other hand, preliminary figures indicate commercial real estate transaction volumes reached JPY 3.5 trillion in 2017, almost similar compared to a year before, with expectations that the final figures could be higher, as lenders maintaining favorable lending attitudes to real estate companies.
- Lower transaction volumes reflected limited deal flow in Central Tokyo, due to a lack of assets on the market and elevated valuations. Domestic investors are still dominant in the acquisition activity thanks to the extremely low capital cost, while J-REITs slowed their investment activities.

Exhibit 25: Real Estate Transaction Volume in Japan

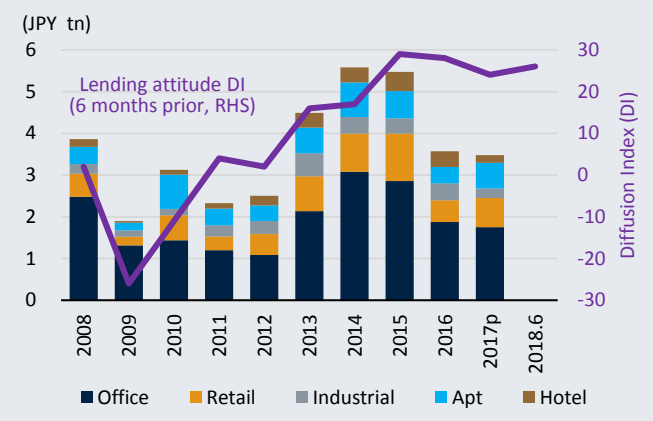
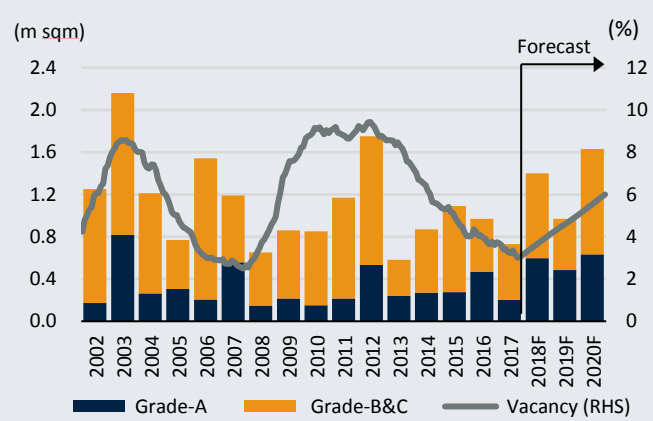


Exhibit 26: Office Supply and Vacancy Rate in Major Cities



Source: Deutsche Asset Management, Real Capital Analytics, Bank of Japan, Miki Shoji, Mori Trust. As of Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Strategic Outlook: South Korea

- South Korea's real GDP is forecast to grow by 3.0% in 2018, slightly higher than the historical average in the last five years of 2.8%. The recovery in 2017 was driven by double-digit growth in exports, while it is expected that private consumption would accelerate the growth in 2018. Geopolitical risks over North Korea remain a threat to a further recovery.
- Bank of Korea raised its benchmark interest rate from 1.25% to 1.5% in November 2017 for the first time in more than six years. The rate hike signaled increased confidence in the economic outlook, while further interest rate hikes in 2018 are also rumored in the market, in order to prevent capital flight and a cool down house prices.
- The subdued employment market left the office leasing demand weak with a recovery expected this year. The recovery of high street retail sales is modest, while it is expected to accelerate when Chinese tourist arrivals fully recover with the political tension between two countries mitigated.
- Expanding transaction volumes and a more diversified investor profile indicate that real estate investment continues to be seen as attractive with yield spreads remaining favourable.

Occupier

- Average office vacancy rates in Seoul rose to elevated levels of 10.5% in the fourth quarter of 2017, 1.0 percentage point higher compared to a year ago. Despite the healthy economic growth, office expansion demand is not strong enough as employment of large corporations has not yet been fully activated, while it is expected to recover modestly toward year-end and in later years.
- With improving consumer sentiments, Seoul high street retail would benefit from a recovery in domestic private consumption and is expected to accelerate further when Chinese tourist arrivals recover with mitigation of political tensions between the two countries.
- Industrial rental growth remains healthy on the back of fast-growing e-commerce and 3PL markets.

Investment

- Preliminary data indicates the 12 month trailing transaction volumes up to the fourth quarter of 2017 was KRW 14.8 trillion, slightly lower than record volumes a year ago but still the second largest transaction volume on record.
- Investor profiles became more diversified with more foreign investors actively chasing opportunities providing relatively higher yield spreads as well as steady capital inflows from both domestic funds and domestic REITs. More investors have been seen switching from core to higher yielding strategies such as lease ups, forward commitments and asset conversions.

Exhibit 27: Real Estate Transaction Volume in Korea

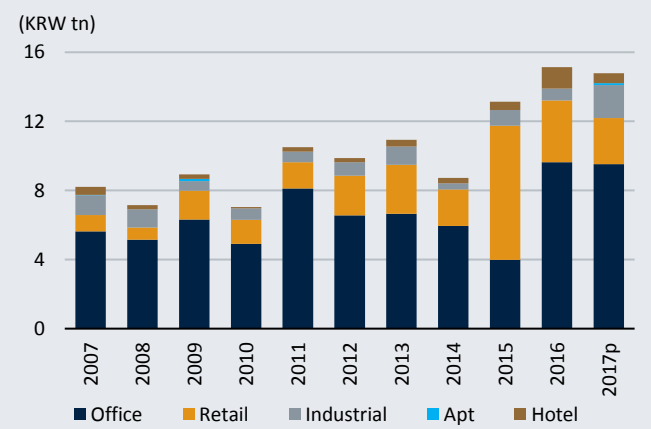
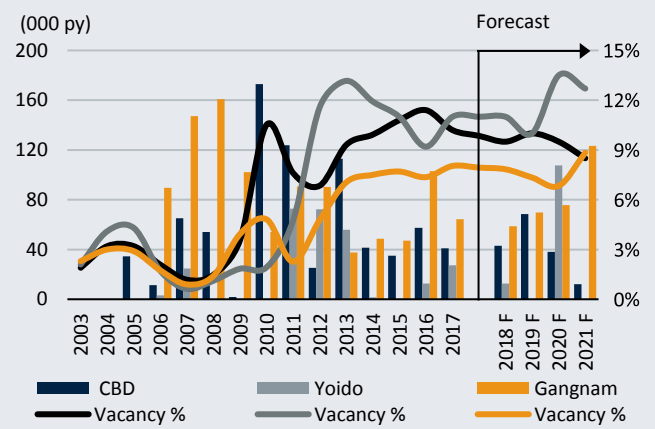


Exhibit 28: Office Supply and Vacancy Rate in Korea



Source: Deutsche Asset Management, Real Capital Analytics, DTZ. As of Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Strategic Outlook: China

- China's economy performed better-than-expected with GDP growth of 6.9% in 2017 underpinned by improving exports, rising housing sales and a construction boom. Nonetheless, tighter capital controls imposed by the government and ongoing deleveraging efforts should likely lead to lower growth of 6.5% in 2018.
- Office leasing activities in Beijing and Shanghai moderated amid increasing caution from occupiers, particularly foreign companies. Rental growth is likely to slow and face downward pressure as newly completed buildings enter the market particularly in Shanghai.
- Investment markets continue to be dominated by domestic institutional investors, most notably insurance companies. Good prospects for modern industrial space underpinned by demand from 3PLs and retailers (e-commerce & traditional).

Occupier

- Overall office leasing demand held up better than expected, despite caution from foreign firms with domestic finance and professional firms the main demand drivers. New supply completions have peaked in Shanghai though Beijing will see vacancy rise from significant supply over the next two years.
- Office rents are expected to soften in Beijing in the near-term given strong competition from high-quality projects in core CBD and secondary areas, while rents in Shanghai should see modest growth underpinned by strong occupier demand and subsiding supply pressures.
- In the retail sector, rents will likely remain largely stable with landlords actively adjusting their tenant mix away from struggling department stores and fashion brands towards F&B, kids' brands and experiential retail.
- Leasing activities in the industrial sector continue to be dominated by 3PLs, e-commerce and traditional retailers.

Investment

- Investment activities remain dominated by domestic capital, most notably from insurance companies. Total transaction volume for the first half of 2017 increased 11% year on year, led by strong investment flows into Shanghai and Guangzhou.
- Overall, office and retail accounted for over 63% of total transaction volume while the apartment sector accounted for another 25%. Meanwhile, transaction volumes in the industrial sector remained thin given the limited availability of assets for sale.
- Foreign investors continued to retain a strong interest in China although many have been priced out of the market given the low yields.

Exhibit 29: Real Estate Transaction Volume in China

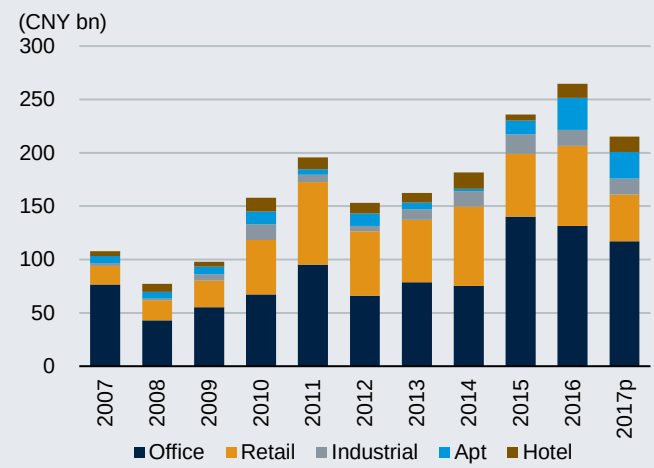
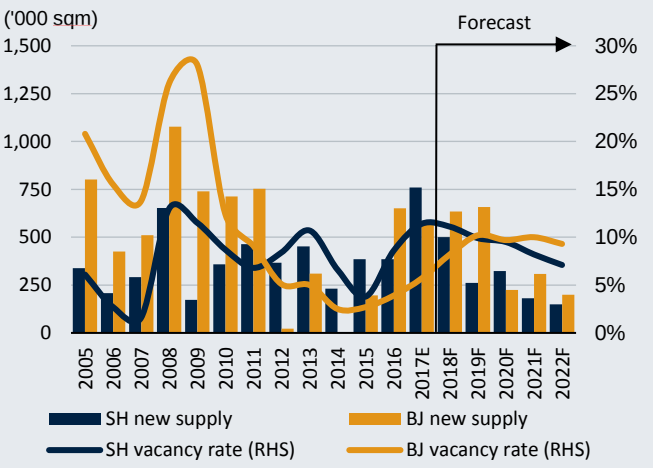


Exhibit 30: Office Supply & Vacancy Rate in Beijing and Shanghai



Source: Deutsche Asset Management, Real Capital Analytics. As at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Strategic Outlook: Hong Kong

- Buoyant asset prices have bolstered consumer spending while the rebound in inbound tourism has aided retail sales performance. Notwithstanding, GDP growth is likely to moderate to 2.4% per annum from 2018-2022 due to weaker exports and slower growth in China.
- Tenant decentralization continues to gain momentum as the rental gap widens between core and non-core areas. Increasing completions of high-quality supply in decentralized areas are expected to cap future rental growth.
- Retail rents are likely to bottom in 2018 on the back of an improvement in inbound tourism and retail sales. Landlords have been adjusting tenant mixes towards more experienced-based, F&B and lifestyle trade.
- Office investment remains predominantly driven by Chinese investors. Higher yield expectations may cap capital value growth.

Occupier	— Widening rental gap between core and non-core areas have encouraged more tenants to relocate to decentralized areas such as Hong Kong East and Kowloon East. Increasing completions of high quality office developments along with significantly lower rents in non-core areas could attract more international financial institutions away from the traditional CBD areas and cap overall rental growth over the next few years. — Leasing demand in the retail sector is expected to improve on the back of an improvement in retail sales and inbound tourism. Landlords have been adjusting to the change in spending patterns and diversifying their tenant mix towards more experience-based, F&B and lifestyle trades. — Demand for warehouse space is expected to be stable supported by recovery in external trade outlook and cost-saving relocation demand. Meanwhile, demand from e-commerce and bricks-and-mortar retailers could gradually strengthen as the retail sector improves.
Investment	— Mainland Chinese investors are expected to remain active particularly in the office sector, purchasing office buildings for self-occupation. — Retail properties located near local residential catchments will remain keenly sought after by institutional investors supported by stable domestic spending. — Investment demand for industrial properties could pick up following the resumption of revitalization policies announced by the government. Investors will focus on industrial properties which can be redeveloped or converted to alternative use.

Exhibit 31: Real Estate Transaction Volume in Hong Kong

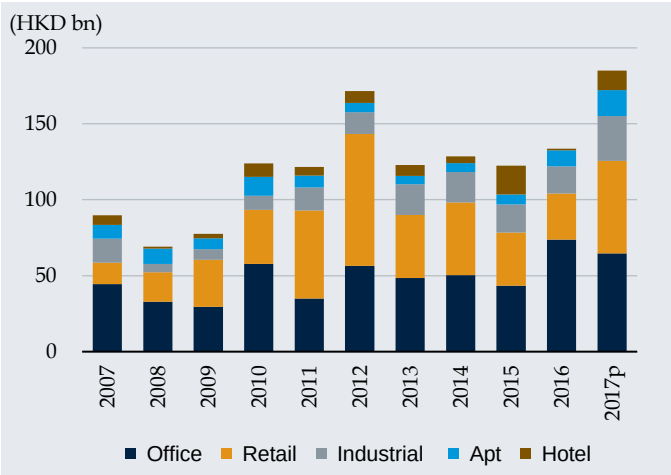
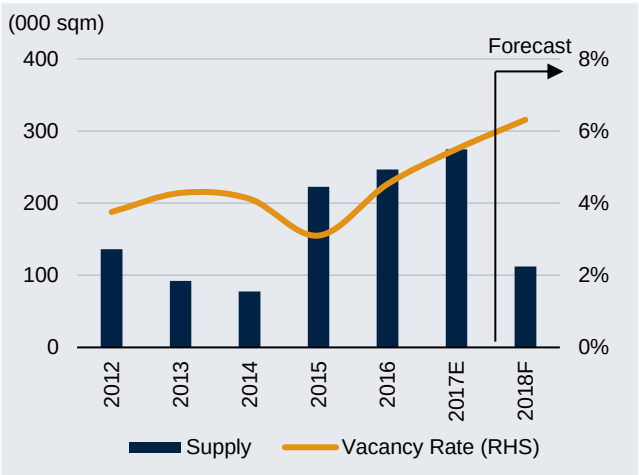


Exhibit 32: Office Supply and Vacancy Rate in Hong Kong



Source: Deutsche Asset Management, Real Capital Analytics, Rating and Valuation Department. As at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Strategic Outlook: Singapore

- Singapore's economy appears on course for recovery on the back of better manufacturing performance and higher export trade as global trade conditions improve. GDP growth of 2.5% - 3% is expected over the next few years.
- Real estate demand-supply dynamics are gradually shifting toward a landlord favourable environment on the back of demand recovery and significant easing in near-term supply pressures.
- Office rentals look poised for recovery over the next few years on the back of positive pre-commitment levels seen in upcoming developments and lower supply pipeline, which should present good opportunities for investors waiting to ride on the rental recovery trend.
- We remain positive on the logistics space underpinned by high income yields, particularly assets with exposure to domestic non-discretionary consumption.

Occupier

- The office market continues to see flight-to-quality trends as tenants look to lock-in current rental rates while relocating to newer buildings with higher grade specifications. Major new developments which have been either completed or nearing completion have achieved healthy pre-commitment levels of 70% and above.
- Office rents appeared to be firmly on a recovery track following a two-year period of decline from the recent peak, although a significant pullback in the supply pipeline over the next few years could set the stage for a multi-year rental recovery.
- The retailing environment remains challenging with operating costs and weaker consumer spending, though prime suburban malls underpinned by local non-discretionary spending are likely to show more resilience.
- Industrial rentals which have been on a downtrend, are projected to see a marginal recovery towards the latter part of the year, underpinned by lower supply completions and improving manufacturing and global trade conditions.

Investment

- Investment volumes surged 55% in 2017, led by collective sales of residential developments. Excluding residential transactions, volumes increased 21% compared to a year ago, led by the S$2.2 billion sale of Jurong Point and S$2.1 billion sale of Asia Square Tower 2 office.
- Strong investor appetite for quality core assets combined with strong balance sheet positions of real estate owners is set to underpin stability in prime yields.

Exhibit 33: Real Estate Transaction Volume in Singapore

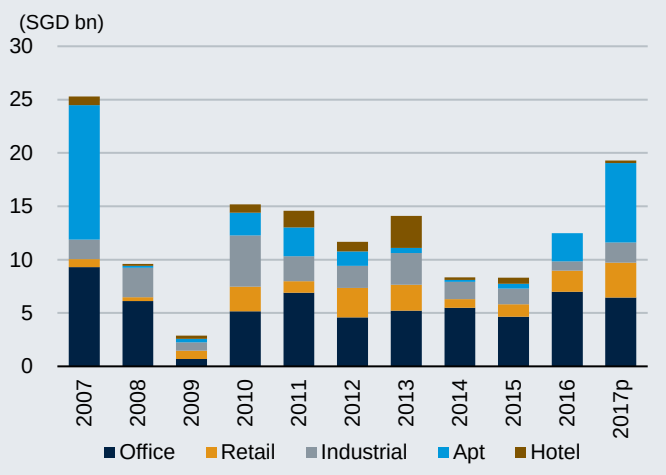
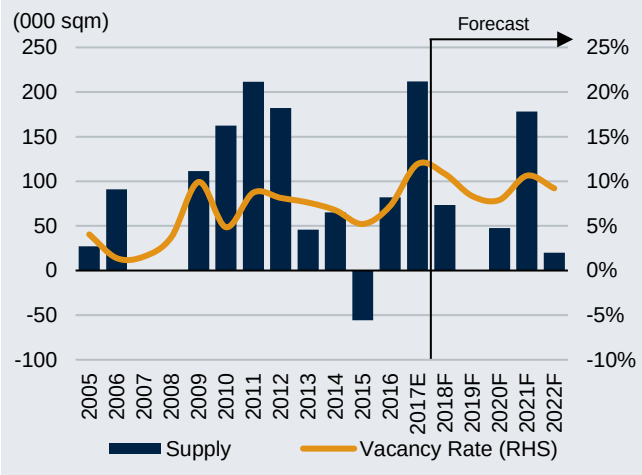


Exhibit 34: Office Supply and Vacancy Rate in Singapore



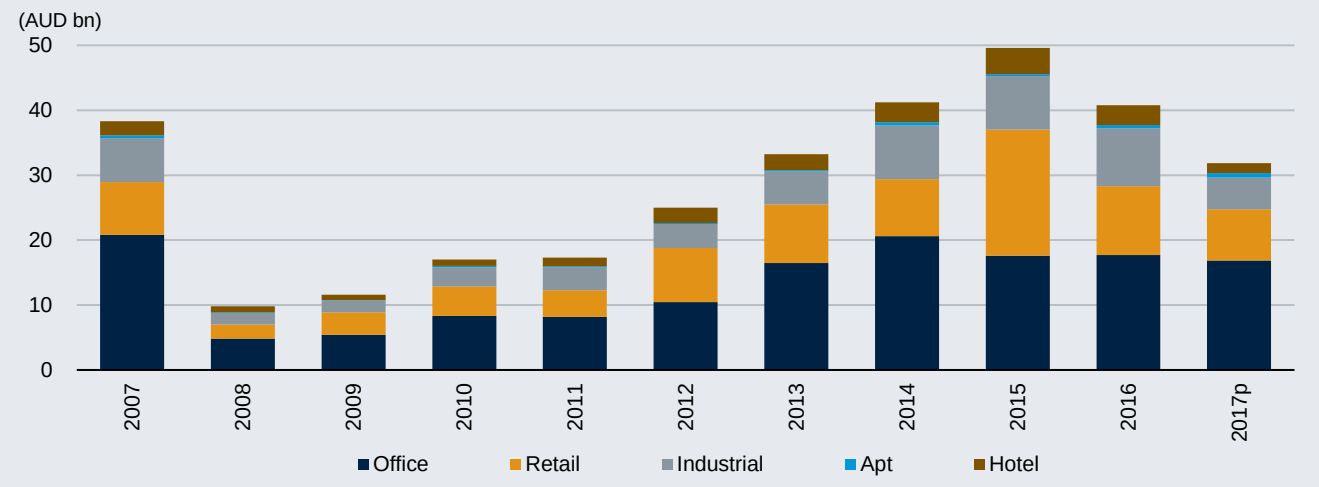
Source: Deutsche Asset Management, Real Capital Analytics, Urban Redevelopment Authority of Singapore. As at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Strategic Outlook: Australia

- Labour market conditions have remained positive and forward indicators including business surveys and job advertisements suggest further job growth ahead. Notwithstanding, household consumption is expected to remain weak amidst further weakness in wages. GDP growth is expected to average circa 2.7% per annum from 2018-2022 in line with the pickup in non-mining business investments as well as LNG exports.
- Tightening vacancy to be accompanied by reduced incentives particularly in the Grade A office segment in Sydney and Melbourne.
- Industrial assets remained keenly sought after given comparatively higher returns.
- Despite the compression in cap rates, spreads relative to government bond yields remain above historical averages, providing a margin of safety should interest rates rise faster than expected.

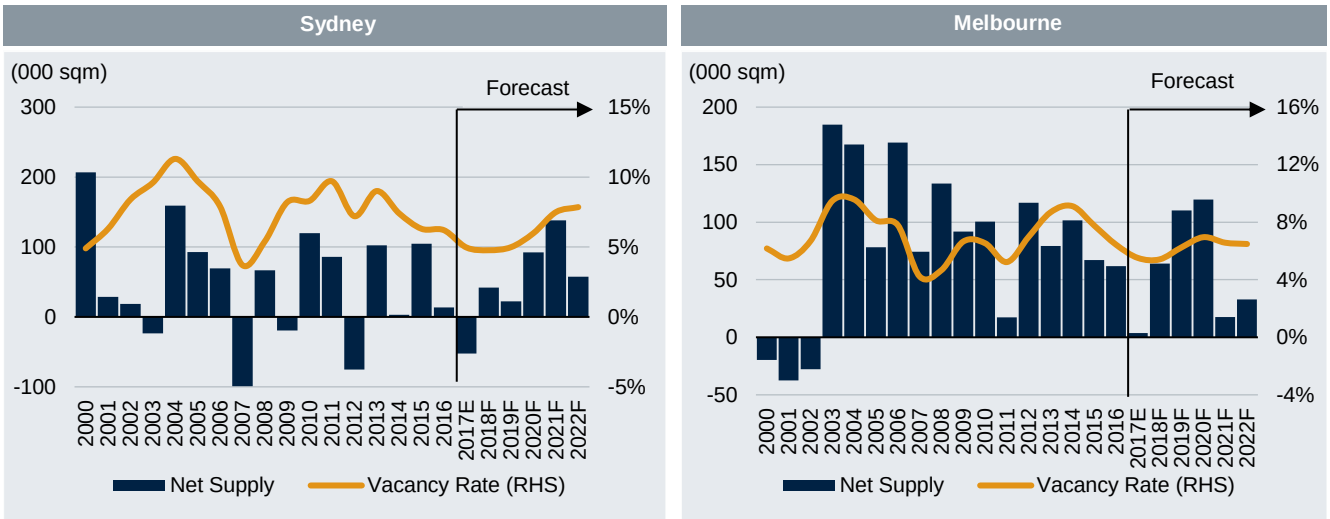
Occupier	— Tenant demand in Sydney and Melbourne has been broad based and mainly driven by organic growth from businesses particularly from the financial and business services sector. Limited new supply in 2018 coupled with high demand is expected to underpin further rental growth. — Leasing demand in the retail sector remains mixed with centres anchored by supermarkets and F&B tenants continuing to perform well while retail centres exposed to discretionary spending continued to face more challenges given the rising competition from international brands and threat from e-commerce. — Outlook for industrial remains positive with continued population growth and limited speculative supply. New take-up to be driven by third party logistics operators as well as existing bricks and mortar retailers expanding their online strategies.
Investment	— Investment volumes fell by 20% in 2017 due to a lack of investable stock for sale. Investors continued to retain a strong preference for the office sector, accounting for over 50% of total investment volume. — Investment demand from domestic and international investors is expected to remain strong given the relatively high spreads to government bond yields and prospects of further rental upside particularly in Sydney and Melbourne offices. — Investors continue to retain a strong interest for industrial properties particularly for assets with strong leasing covenants.

Exhibit 35: Real Estate Transaction Volume in Australia



Source: Deutsche Asset Management, Real Capital Analytics, As at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

Exhibit 36: Net Office Supply and Vacancy Rate in Sydney and Melbourne



Source: Deutsche Asset Management, Colliers as at Feb 2018.
Note: F = forecasts. There is no guarantee the forecasts will materialize.

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