eastspring investments

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MARKET INSIGHTS

BUILDING A HOUSE OF VALUE - RIDING ASIA'S STRUCTURAL GROWTH

JANUARY 2016

Rapid growth in population and the changes in demographics in the last 50 years paint a consistent picture that there has been significant global and Asian urban population growth (United Nations Population Fund). This provides structural demand for various property assets, not just for urbanites to live and work in, but also for businesses to flourish.

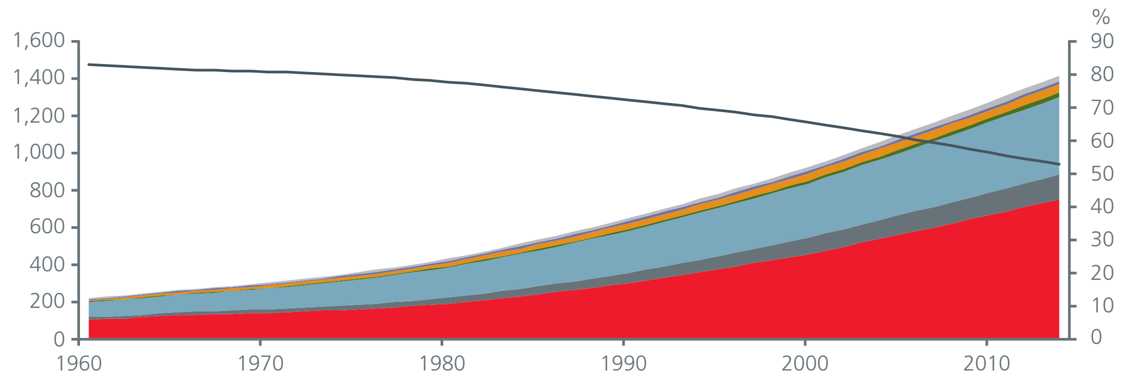
WHY INVEST IN ASIAN PROPERTY

We believe investing in Asian property assets can be a successful long term strategy and we outline some key reasons below:

1. Urbanisation

Strong urbanisation trends have been observed in Asia and this growth has been higher than the overall population growth. Modern housing and commercial property form a major infrastructure of new urban areas.

Fig.1. Urban areas continue to see significant population growth

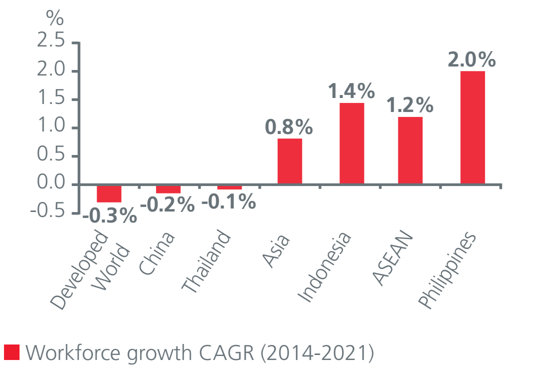


Source: World Bank Databank, as at August 2015.

2. Supportive demographics and a large population pool

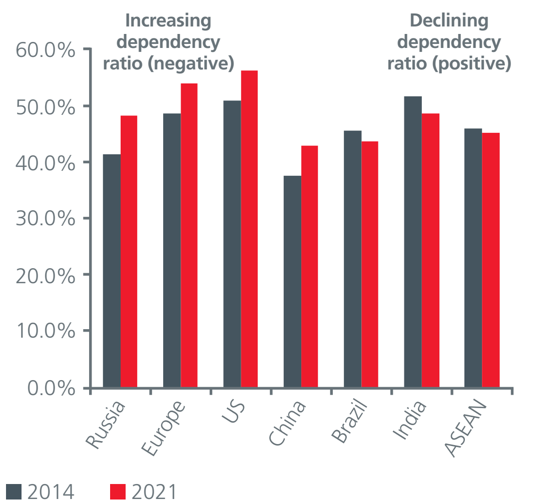
An important ingredient of economic growth is human capital. A rise in the working population translates to a larger base of labour capital input, which the country can tap on for raising its output. Asia currently shows the potential for more room for expansion in the absolute number of working adults, as compared to countries in developed markets.

Fig.2. More working adults allow economies to grow by increasing output



Source: United nations & Haver, as at January 2015.

Fig.3. Workforce growth CAGR (2014-2021)



Source: United nations & Haver, as at January 2015.

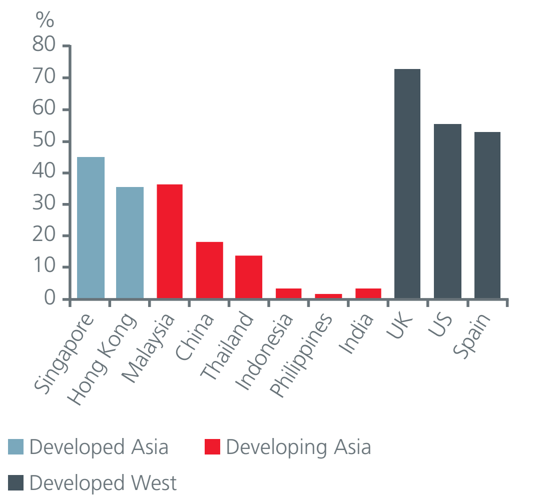
Together with an increase in the absolute size of workforce, more workers will also move into the middle-aged bracket, with relatively higher disposable income. Over time, the shift in demography will also lead to a need for countries to develop more value-added sectors and infrastructure to tap on the skills of its mature workforce. This is expected to unfold over the long-term in Developing Asia.

To accommodate a population which is growing in size and has longer life expectancies, there will also be demand from pension funds to seek stable and sustainable returns from long-term investing opportunities – a profile which typically matches that of property assets.

3. Developing Asia households have room to spend more on property

Financing supports the ability to purchase large ticket residential properties. As banks develop mortgage products and extend their customer reach – their penetration will increase and help support residential purchases and prices. Mortgage to GDP (Fig. 4) is much lower in Asia vs rest of developed world.

Fig.4. Developing Asia expenditure on property has not reached the level of developed markets



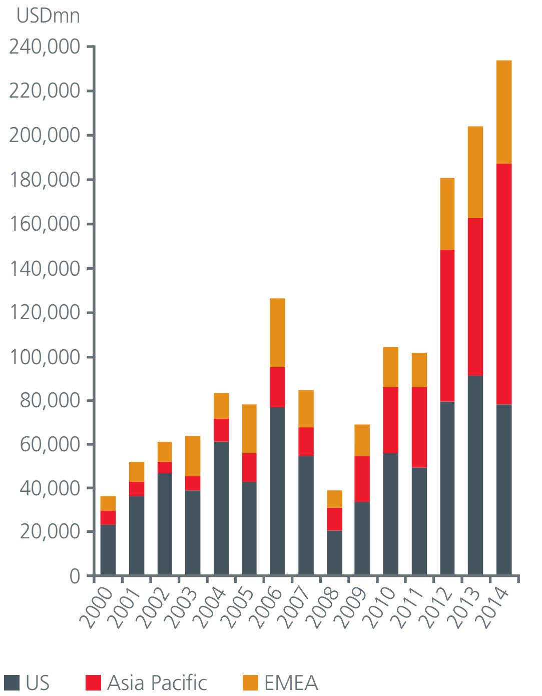
Source: Haver UBS estimates, as at February 2015.

4. Property has become an established asset class with supportive funding access

Property as an asset class has attracted the interests of longer-term investors such as pension funds, sovereign wealth funds and large institutions. The long duration of these assets and their higher yields make them attractive relative to government bonds. Debt markets continue to develop in the Asia Pacific – providing long duration funding and diversification of funding channels for property asset owners.

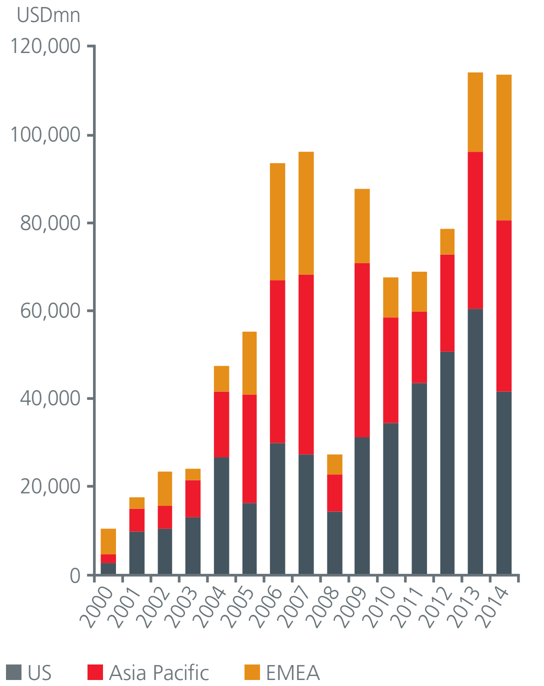
With more investment grade properties coming in the supply pool with a steady rental stream, plus transactional evidence, price transparency has improved. This is supportive of property investments including REITS (Fig. 5 & 6) – improving the size of the debt and equity markets.

Fig.5. Corporates able to raise both debt and equity in Asian markets - Debt raising



Source: UBS estimates, as at July 2015.

Fig.6. Corporates able to raise both debt and equity in Asian markets - Equity raising



Source: UBS estimates, as at July 2015.

ATTRIBUTES OF PROPERTY FUND INVESTMENTS

1. Enjoy both growth and income

A diverse property portfolio of developers and Real Estate Investment Trusts (REITs) offer higher earnings growth at the right time in the cycle, but steady dividend income through cycles. An example of select developer and REIT names in Fig. 7 show the drivers of performance over a 10-year period between growth and income.

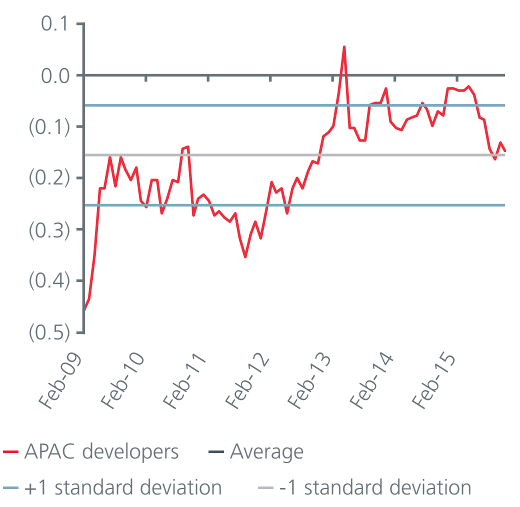
Fig.7. Attractive dividends and price appreciation (November 2005 - November 2015, local currency)

REITS	Total annualised return	% of return due to dividend reinvestments (income)
Capitaland Mall Trust	5.6	94.8
Link REIT	19.6	41.3
Developers	Total annualised return	% of return due to capital appreciation (growth)
China Vanke	27.0	82.3
Summarecon Agung	30.3	87.7

Source: Bloomberg data, as at 30 November 2005 - 30 November 2015.

2. Asia property developers' valuations are attractive

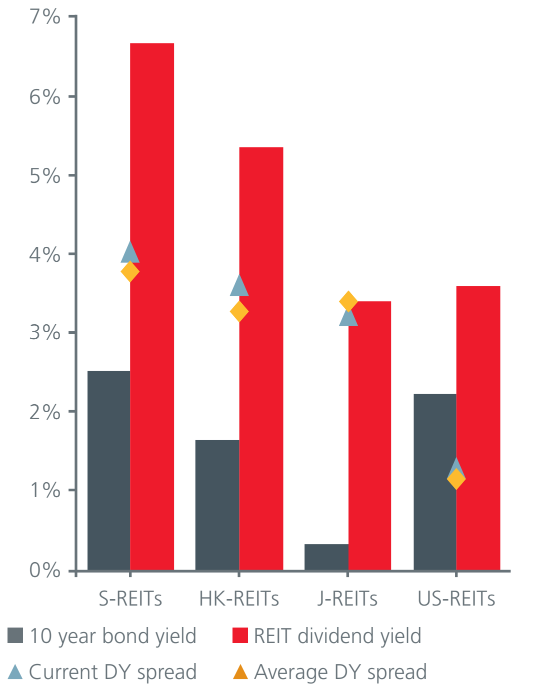
Fig.8. Asia Pacific all countries developers, historical discount-to-NAV



Source: UBS, as at 30 November 2015.

3. Asian REITs currently offer both absolute and relative yield opportunities in comparison with a natural peer of long maturity government bonds

Fig.9. Regional REIT yields continue to offer a premium over government bonds



Source: UBS estimates, Thomson Reuters Datastream, as at November 2015. DY = Dividend yield.

Attractive yields in Asia's REIT markets are supported by the strong cash flow nature of the underlying property assets such as retail malls, offices, industrial or logistics properties. In addition, select Asia REITs' continue to offer dividend premiums relative to government bonds.

REIT yields have already priced in moderate US rate hikes and although there has been volatility in the market, we believe that REIT valuations should hold up even if the U.S. Federal Reserve continues to move rates up. Duration lengthening and interest rate hedging has been employed by REITs to reduce the short term impact of rate and currency changes.

ASIA PROPERTY OUTLOOK

Australia, Hong Kong and Singapore make up over 80% of the Asia Pacific ex. Japan Property market by market capitalisation.

1. Australia

Strong corporate governance, deep management resources and capabilities, and a transparent physical market dominated by private players are conducive to investment. Valuations of Australian property stocks and REITs have eased considerably in the past three months, but outperformed the MSCI Australian market YTD (0.7% vs -7.0% on a total return basis[1], in USD). Attractive dividend yields, lower interest rates, rational supply and foreign investments in direct physical properties after the weakness in the AUD, currency fall have lent support to the market. The Portfolio Manager sees value in both retail and residential REITs.

2. Singapore

High-dividend names have seen prices broadly corrected by nearly 10% in the past six months and dividend yields relative to 10 yr government bonds are a high of more than c.3%. Most REITs are conservative in their balance sheet (gearing levels <35%) and funding cost although rising – is more diversified across channels (bonds, banks, preference shares etc) and higher duration. This provides more stability to net yields of the properties and the dividend yield of the REITs.

Developers have suffered share price declines from the easing residential property cycle; supply is rising whilst interest rates are easing. Against this backdrop, there exist robust listed developers with healthy cash levels on their balance sheets and hold low inventory levels (in land and finished goods).

While the outlook for earnings may be weaker due to lower sales, select developers with healthy balance sheets have the option to diversify into new markets, buy land at lower prices or collect rental income from their existing investment portfolios. The Portfolio Manager prefers developers with deep discount to their book values and a good historical track record in execution.

3. Hong Kong

The Hong Kong residential space is still in undersupply since the household formation growth has been rising faster than land supply. The population household gearing levels remain low as well. In addition, developers' balance sheets are strong enough to take advantage of purchasing undeveloped land as an investment strategy and also executing within healthy timelines for turnover of assets. Market prices already reflect declines in average selling prices, and discounts to NAV are wide.

Due to limited land supply and an already high density in Hong Kong, new commercial property supply has been scarce. Office vacancies at 1+% are the lowest in the developed world. Retail rents tend to peg to shorter term retail sales – due to landlord's incentive to capture rental upside on the strong Chinese tourist expenditure but this has been suffering headwinds in the last 1-1.5 years on the back of an anti-corruption drive in China, strong HKD which is pegged to USD, and Chinese tourists travelling further afield.

The overriding fear is the depreciation of the HKD and the risks to asset prices. HK capitalisation rates are amongst the lowest in the world especially in retail properties. The HK government has limited room to manage monetary policy as it takes interest rates form the Fed as its currency is pegged to the USD. The RMB easing may reduce demand for its goods and services, including property assets - and reduce the HK companies' overall competitiveness. The Portfolio Manager is of the view that this remains a tail risks and is watchful of asset price valuations. The developers that we prefer trade well below book value and are mostly in a strong cashed-up position, reducing this risk.

[1]Source: Bloomberg, as at 1 December 2015.

4. China

China macroeconomic and liquidity conditions have been easing dramatically. The housing market will be a key lever of the Chinese government in stimulating the GDP of the country. The market has become mature in residential housing with many players, and competition for land. The market is significantly oversupplied in the commercial space. Being cognizant of this, the portfolio manager avoids companies with a large number of development properties in the commercial space.

However, we are constructive on developers with strong balance sheets, and higher asset turnovers – that will be able to sustain or improve growth prospects from supportive government policies. The Chinese property developers segment is a standout in the country relative to other old world industries that are going through declines in profitability.

CASE STUDY – DEVELOPERS OFFER GREAT GROWTH OPPORTUNITIES

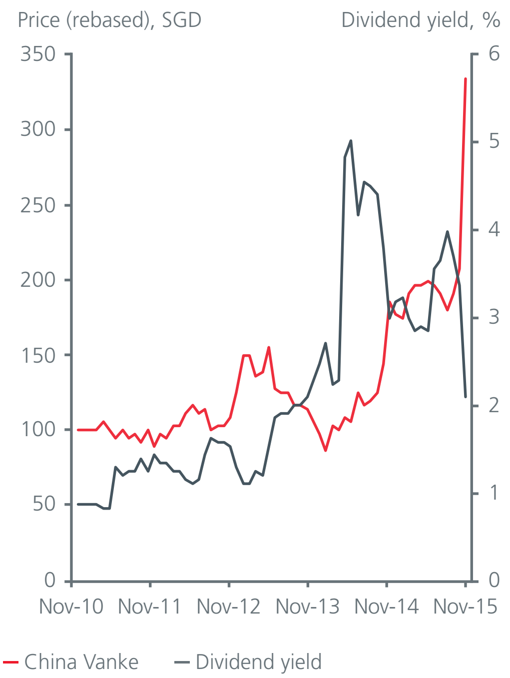
The market's gyration and attention paid to the macroeconomic outcomes of the new RMB (Renminbi) regime has not changed our strategy. The Portfolio Manager remains focused on investing in a diversified portfolio of high-yielding, attractively-valued companies with strong cash-generative business models, and undervalued sustainable earnings.

China Vanke Co. is an example of such a company. China Vanke develops residential properties in some of China's larger cities, such as Beijing and Shanghai. The stock has enjoyed appreciation in its price as well as moderate growth in dividend yield.

The Chinese property developer is a fundamental blue chip name in the sector. We observe management to be disciplined, operating an efficient "manufacturing model" that generates high asset turnover which reduces inventory risk and improves cash flow generation.

Management has taken a conscious, prudent approach to its balance sheet. In general, listed Chinese developers have been highly reliant on offshore capital markets funding – often issuing USD-denominated debt. Issuing debt offshore leads to ill-matched currency exposures. A prudent strategy is to have diversified funding and a fully hedged book – and in this regard Vanke stands out. As a result, we believe the company can utilize its healthy balance sheet to quickly respond to market conditions if they improve by accelerating construction activity.

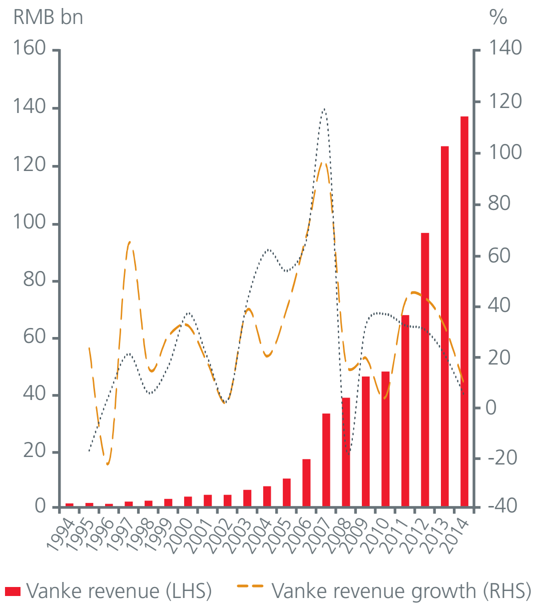
Fig.10. China Vanke – offering growth from capital appreciation



Source: Bloomberg, Eastspring Investments as at 31 December 2015.

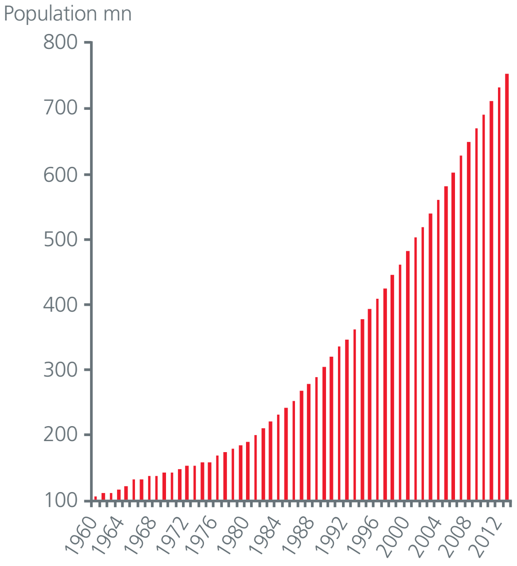
Vanke started in 1988 and has since concentrated its focus on residential development. The company grew quickly (Fig. 11) as it rode the wave of the housing market boom in China in the early 2000s, an example of how investing in property assets allows one to benefit from exposure to the larger trend of population growth (Fig. 12) and urbanisation.

Fig.11. Growth of China Vanke since 1990s



Source: Goldman Sachs Research, as at August 2015.

Fig.12. Population growth of China



Source: Goldman Sachs Research, as at August 2015.

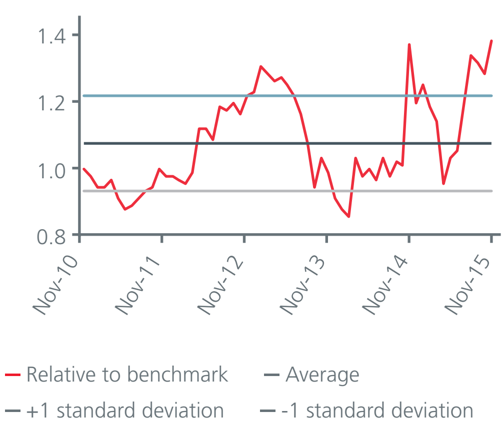
At December 2015, the company's share price has outperformed its peers in the country and is beginning to look fully valued.

As of late, recent corporate actions have occupied investors' attention; the stock was temporarily suspended in December 2015 due to potential announcements concerning an asset restructuring by the company's management to address the recent significant increase in stake by a financial services/ insurance firm.

We remain positive on China Vanke; it is one of the most well-run property developers in China and its high quality management has a strong focus on shareholder returns, asset turnover and ROE. The Portfolio Manager is of the view that fundamentals that underpin growth of the company and China's property market have not changed.

The company's stock is now trading at relatively attractive metrics of 4% fwd yield; 1.6x P/B with 19% ROE. And we expect the payout ratio / dividend will increase over the year as they find it more challenging to find high ROE investment opportunities.

Fig.13. Historical price-to-book chart for China Vanke



Source: Bloomberg, as at 2 December 2015. Benchmark - Shanghai Stock Exchange Property Index.

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