Morgan Stanley

INVESTMENT MANAGEMENT

2017 Mid-Year Commercial Real Estate Outlook for Asia Pacific

REAL ASSETS | REAL ESTATE INVESTING TEAM | INVESTMENT INSIGHT | 2017

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The global macroeconomic landscape continues its shift away from highly accommodative monetary policy, deflation and the low-growth environment seen over the past five years, towards fiscal stimulus, reflation and a higher-growth environment. Against this backdrop, Asia Pacific's economy is gaining momentum, benefiting from stronger global growth as well as more aggressive fiscal stimulus packages. In addition, structural trends, such as demographic and technological shifts continue to influence growth patterns and investment strategies in the region. Morgan Stanley Real Estate Investing (MSREI) believes these factors continue to create a very favorable environment for real estate investing across Asia.

Macroeconomic Environment

Global GDP growth is expected to accelerate to 3.6 percent in 2017 and 3.8% in 2018, from 3.0 percent in 2016, led by private sector demand and increased business investment. The Asia Pacific region is expected to grow by 5.7 percent in 2017 and 5.6 percent in 2018, 2.5 times the rate of growth expected in the United States and Europe[1]. In Japan,

[1] Morgan Stanley Research, June 2017

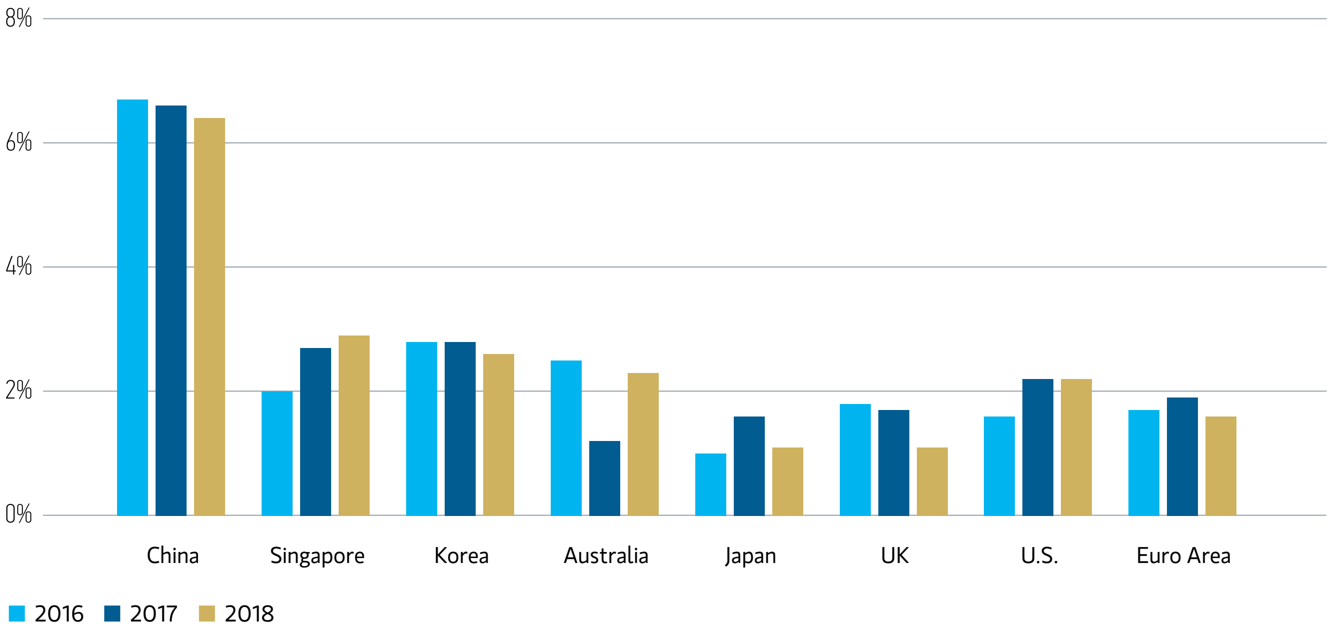
Morgan Stanley Research has upgraded GDP growth from 1.3 percent to 1.6 percent (2017) and 0.9 percent to 1.1 percent (2018) primarily because of stronger export growth (which reached 6.1 percent in 1Q 2017[2] emanating from a weaker yen. Household consumption remains modest because wage growth has yet to meaningfully accelerate. Morgan Stanley Research expects the Bank of Japan (BoJ) to maintain their 0% yield target on the 10-year government bond in the near term, which should continue to support the economy. The potential exists, however, for rate hikes starting in 2018. South Korea is also benefiting from the recovery in global trade, with exports rising at an annualized pace of 8.7 percent in the first quarter, contributing to a strong first quarter, GDP growth of 2.9 percent.[3] Morgan Stanley Research has upgraded GDP growth from 2.4 percent to 2.8 percent (2017) and 2.3 percent to 2.6 percent (2018), despite lingering concerns over North Korea.[4] Under the newly appointed President, Moon Jae-in, Morgan Stanley Research anticipates that South Korea will adopt a more proactive approach to foreign policy which could lead to a more conciliatory tone toward North Korea and improved relations with China, potentially mitigating some of the geopolitical concerns[5].

In Australia, first quarter GDP growth slowed to 1.7 percent year-over-year and further moderation is likely due to the slowdown in the housing market and personal consumption.[6] Rising inflation and housing risks likely will allow the Reserve Bank of Australia to maintain the current policy rate at 1.5 percent. China's growth surprised on the upside

DISPLAY 1

Forecasted GDP Growth[7]

By Country



Source: Morgan Stanley Research, data as of June 2017

[2] Japan Cabinet Office, Moody's Analytics, as of July 2017

[3] The Bank of Korea, Moody's Analytics, as of July 2017

[4] Morgan Stanley Research, as of June 2017

[5] Source: Morgan Stanley Research

[6] Australian Bureau of Statistics, Moody's Analytics, as of July 2017

[7] The opinions expressed herein are those of the MSREI team as of the date of the presentation and are subject to change at any time due to changes in market or economic conditions. Readers should be aware that forward-looking statements, and statements regarding MSREI's assessment of the market are by their nature inherently uncertain insofar as actual realized returns or other projected results can change quickly based on, among other things, unexpected market movements, changes in interest rates, legislative or regulatory developments, acts of God, and other developments.

in the first and second quarters, accelerating to 6.9 percent year-over-year, ahead of the government's annual target of 6.5 percent, suggesting a hard landing remains a low probability[8]. Further moderation is expected throughout the remainder of the year, however, as a calibrated monetary policy tightening slows credit growth and fixed investment. With its high export orientation, Singapore is well positioned to benefit from stronger global growth, GDP growth has been upgraded from 1.5 percent to 2.7 percent (2017) and 1.8 percent to 2.9 percent (2018).[9] Hong Kong has also benefited from the global synchronous recovery, with year-over-year GDP growth rising to 4.3 percent in the first quarter.[10] Given the expectation of only a moderate slowdown in China, growth in the Asia Pacific region should remain strong over the next two years.

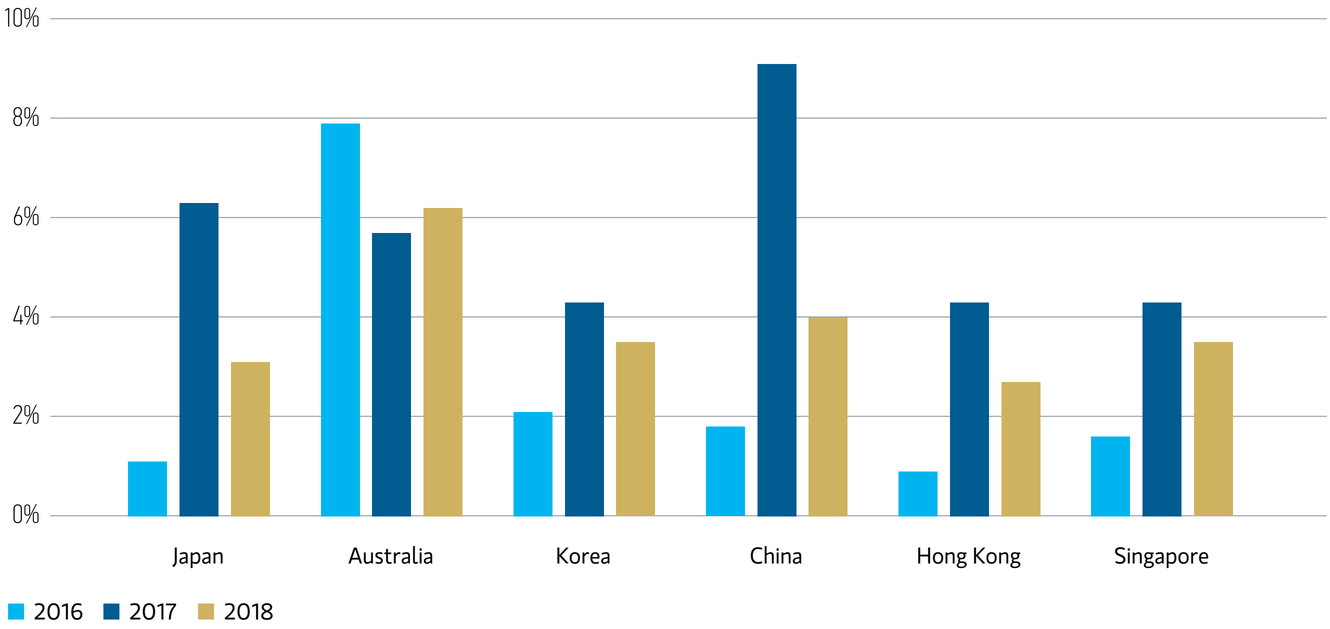
Structural Trends

Structural trends continue to play an increasingly important role in economic growth patterns and investment strategies across the region. Demographic trends, including aging populations, the rise of millennials, the growing middle class and urbanization are contributing to different living, spending and working preferences which are creating attractive opportunities in the retail and office sectors. Asia has the highest share of millennials (33 percent) versus the Americas (31 percent) and Europe (25 percent) and this has contributed to continued urbanization particularly in markets such as China and India.[11] Driven by currency depreciation and surging demand from China, international tourism has rapidly increased, particularly in Japan and South Korea. This has created attractive opportunities in the retail and hotel

DISPLAY 2

Exports Picking Up

By Country



Source: Oxford Economics, data as of June 2017

[8] Morgan Stanley Research July 2017

[9] Morgan Stanley Research, as of June 2017

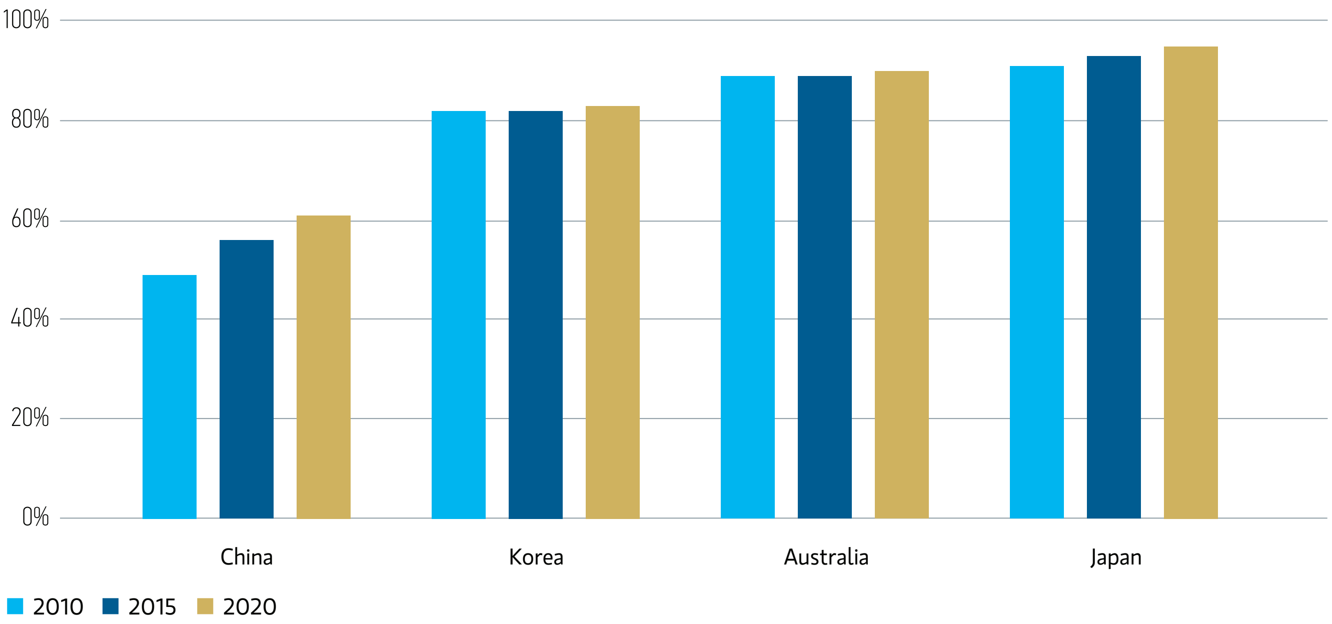
[10] Hong Kong Census and Statistics Department, Moody's Analytics, as of July 2017

[11] UN Population Division, World Population Prospects, as of December 2016

DISPLAY 3

Urbanization Continues[12]

Share of Population Living in Urban Setting

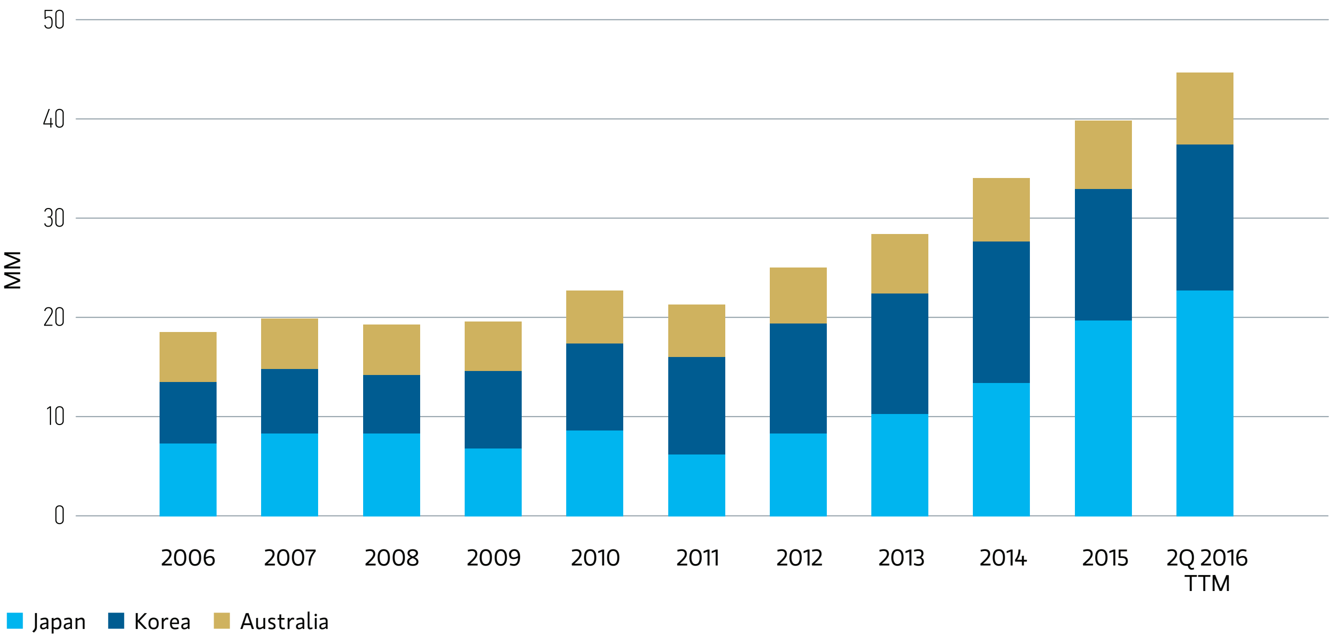


Source: UN Population Division, World Population Prospects, 2015 Revision, MSREI Strategy, data as of October 2016

DISPLAY 4

Number of Inbound Guests

Annual



Source: Japan National Tourist Organization, Korea Tourism Organization, Tourism Australia, MSREI Strategy, data as of January 2017

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sectors. Lastly, e-commerce penetration and growth rates are higher in several countries in Asia (13 percent in Korea and 17% in China) than in the United States (10 percent)[13], creating opportunities in the logistics sector.

Real Estate Implications

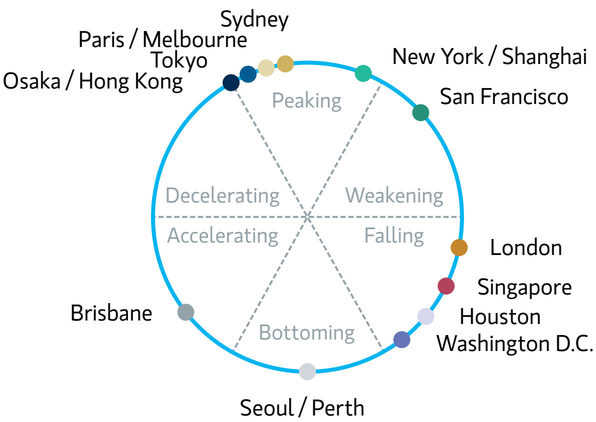
The real estate environment in Asia Pacific continues to remain attractive, with steady fundamentals and cap rate compression evident in most major markets, leading to robust regional returns. Across the region's major office markets, year-over-year rent growth averaged 3.3 percent in first quarter 2017, down from 3.6 percent in fourth quarter 2016 and 4.3 percent from year-ago levels[14,15]. Melbourne and Sydney witnessed particularly strong rent growth of 7 percent and 14 percent, respectively. Office rent levels remain below prior peak levels, allowing additional room for rent growth. In Tokyo, for example, office rents are 30 percent below the prior peak, Singapore rents are 55% below peak, while Seoul rents are at the prior peak.[16] With regional economic growth expected to remain stronger than European and the United States growth, and new supply expected to remain below the historical average, office rent growth for primary markets is expected to average 2.3 percent over the next five years compared with 2.2 percent in the United States and 1.3 percent in Europe.[17] Office cap rates across the region compressed on average by 20 basis points, contributing to price growth of 4 percent over the past year through first quarter 2017.[18] This price growth exceeded major markets in the US and Europe (2 percent and -4 percent respectively), which is not surprising given the real estate cycle in Asia generally has lagged the U.S. and Europe (Asia's office real estate values are still 5 percent below their prior peak, compared with 15 percent above peak for the United States. and 6 percent above for Europe).[19]

Strong labor markets are contributing to higher income growth, helping boost personal consumption levels in the region. This, combined with the rapid rise in tourism and continued urbanization, is benefiting the retail sector, as well as the logistics sector, which continues its transition from an alternative asset class to a core, institutional asset

DISPLAY 5

Market Cycle[20]

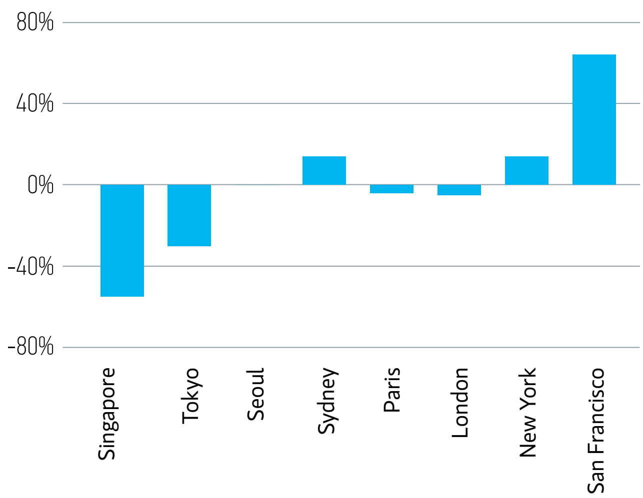
Office Sector



DISPLAY 6

Office Rents Still Below Peak Levels

1Q 2017 Office Rents as a Percent of Prior Cycle Peak



Source: PMA, CoStar, MSREI Strategy, data as of July 2017

[13] Morgan Stanley Research, May 31, 2017

[14] Major markets include Tokyo, Sydney, Melbourne, Seoul, Hong Kong and Singapore

[15] Property Markets Analysis, as of July 2017

[16] Source: Property Market Analysis, as of July 2017

[17] Major markets only. Property Market Analysis, Costar, as of July 2017

[18] Ibid.

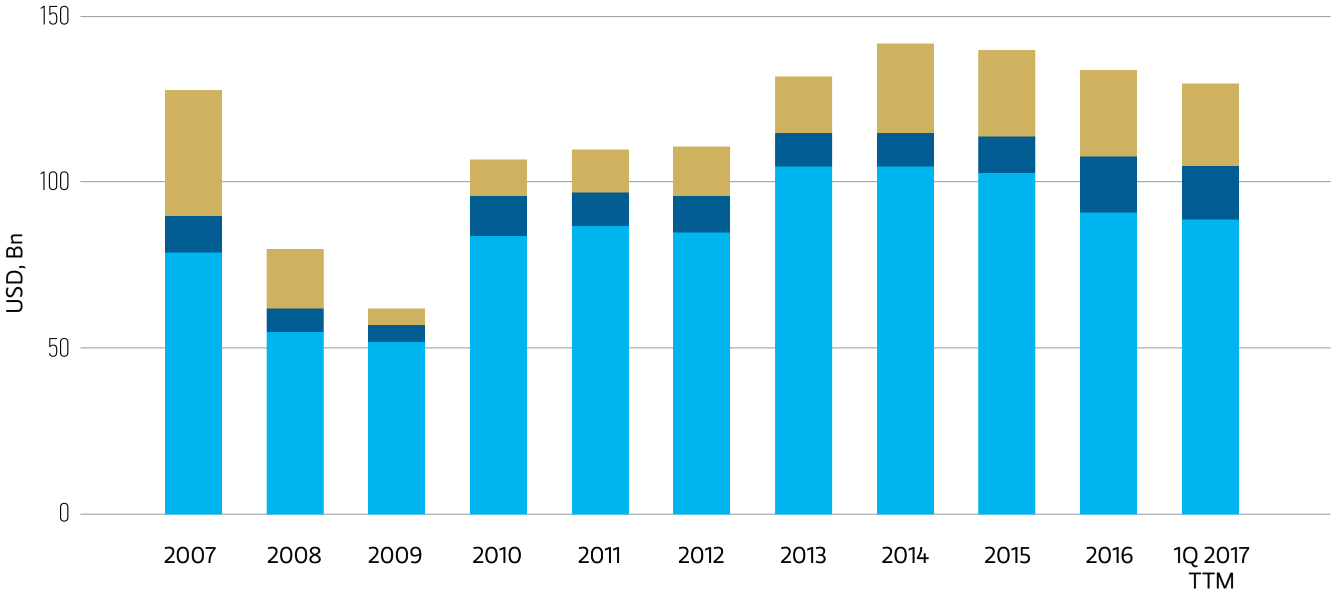
[19] Property Market Analysis, CoStar; peak defined as the individual market's highest point over 2007-2008, as of July 2017

[20] The market cycle positioning framework is the outcome of the use of an internal tool being developed by MSREI based on a consistent set of real estate metrics available on a country-by country basis. It is aimed to help identify drivers of market performance, market positioning relative to prior cyclical peaks and troughs, turning points and implications for investing strategies. It is updated on a quarterly basis in line with the release of macroeconomic and commercial real estate data. The tool uses a mix of real estate fundamentals and capital markets metrics that are generally available in applicable countries (including rent, occupancy, cap rates and spreads and liquidity and values metrics). The majority of the metrics are based on "actuals", versus relying on forecast data. Note that other outcomes could result if different inputs or assumptions are made. The market cycle positioning constitutes a "forward looking statement." Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statement.

DISPLAY 7

Asia Transaction Volume by Capital Source

Office, Industrial, Retail and Apartment Transaction Volume

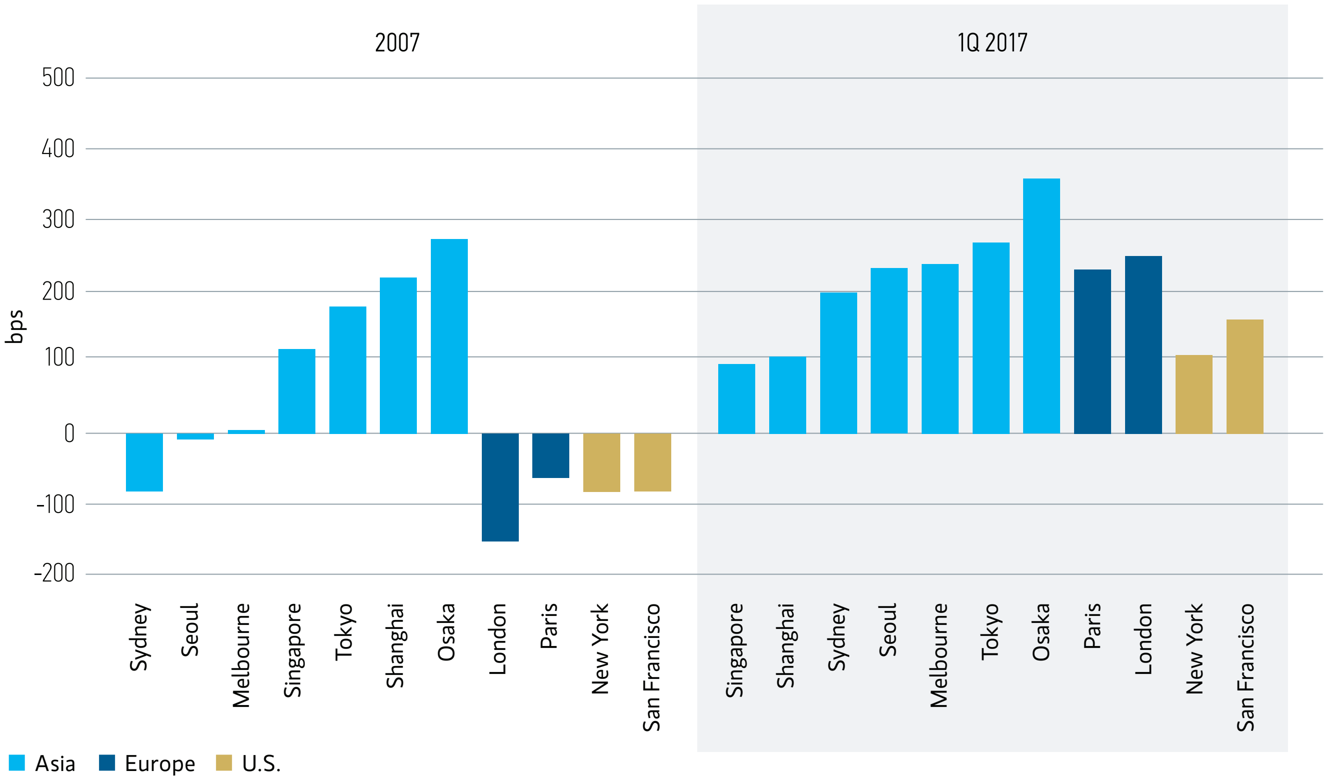


Source: Real Capital Analytics, MSREI Strategy, data as of June 2017

DISPLAY 8

Prime Office Yield Spreads to Risk Free Rate

Prime office yield over 10-year government bond yield



Source: PMA, NCREIF, Bloomberg, MSREI Strategy, data as of June 2017 class. Logistics cap rates have compressed at a faster rate than traditional asset classes (e.g., 250 basis points over the past five years versus 150 basis points for the office sector) and may continue to compress further over the coming years[21]. Lastly, continued urbanization and affordable housing challenges in the region are continuing to drive investor interest in the for-lease residential sector, particularly in markets such as South Korea, China and Australia, in addition to Japan where the sector has been generating stable returns of 6.9 percent per year since 2010[22].

Capital Markets

In general, interest rates and borrowing costs remain very low, providing attractive spreads for investors and encouraging strong market liquidity. Global investors are increasingly attracted to the region with global capital flows increasing fourfold since 2009 and now accounting for 25 percent of the region's investment activity, which remains robust at US$130 billion per year.[23] Global capital inflows largely have targeted primary markets in the region, where capital values have increased by 72 percent since the trough versus 26 percent for secondary markets.[24] As the Asia-Pacific region grows and develops, it is increasingly a staple in global real estate portfolios. Whereas five to ten years ago, investors—particularly foreign investors—would only venture to the region for opportunistic returns or development plays, the opportunity set today has grown to include more cash-flow or core-oriented strategies. The invested stock over the last ten years has grown by a multiple of three, to more than $5 trillion.[25] Vast amounts of capital formation in the region have made the top eight markets in Asia as active and liquid as the top eight markets in Europe or the United States.[26]

The Path Ahead

MSREI expects the investing environment in Asia Pacific will remain attractive over the next several years driven by strong regional growth and a favorable capital markets environment. MSREI believes asynchronous growth drivers, real estate markets at different cyclical points and shifting structural trends may continue to provide attractive risk-adjusted returns across the major sectors and countries within the Asia Pacific region.

[21] Average yield compression in Melbourne, Tokyo and Seoul (2012Q4-2016Q4). Source: CBRE, PMA

[22] Source: IPD, July 2017

[23] Real Capital Analytics, as of July 2017

[24] Property Market Analysis, as of July 2017

[25] DTZ Money Into Property, as of 2015

[26] Real Capital Analytics, MSREI Strategy, as of July 2017

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