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Investment Philosophy
Once considered an ‘alternative’ investment asset class, investing in REITs has been growing in popularity. Attracted to the stable and high levels of yields as well as robust total returns, global institutional investors have been increasing their allocations to this asset class, according to a recent survey by investment bank UBS. In addition, investors are paying more attention to investing in the Asia region than ever before and this includes a focus on Asian REITs.

The reasons for the attractiveness of Asian REITs are clear. Asia is considered to be the ‘world’s growth engine,’ with GDP growth rates in Asia ex-Japan typically in the 6% - 8% range while the major market economies in the West are struggling with low or no growth. In addition, many countries are continuing the process of urbanisation, that is, more of the population are migrating from the countryside to the cities, which will impact the demand for all types of property such as houses, hospitals, shopping malls and offices. REIT structures benefit from tax efficiencies and legislative frameworks that provide a reassurance to investors. For investors in the search for income, REITs are a viable option.
Growth of the Asian REIT Market

Although REITs have been around since the 1960s in the United States, the Asian REIT market only started to take off in 2002. Since then, the Asian REIT market has exploded, both in terms of the number of listed REITs and in terms of market capitalisation.

Singapore and Hong Kong dominate the Asian REIT market, in terms of size and sophistication. In Singapore, the first Singaporean REIT (S-REIT) was listed on the Singapore Exchange in 2002. Since then, the S-REIT market has grown to be the largest in Asia ex-Japan. Hong Kong’s REIT market, established in 2003, is the second largest and provides investors with access to Hong Kong and Mainland China real estate. In 2011, the world’s first RMB-denominated REIT with major property assets in Mainland China was listed in Hong Kong. In contrast, Malaysia’s REIT industry was one of the earliest to launch in Asia in 1989 but to date it is still a relatively small market and considered by some to be an untapped market. Thailand has the largest number of REITs in Asia, although in terms of total value, the market remains small.

Favourable legislative structures and ‘tax transparency’ have contributed to the growth of the Asian REIT market. For example, in Singapore, as long as the REIT distributes more than 90% of its taxable income, ie income derived from the management or holding of property and not the gains on the sale of a property, tax is only levied on the unitholder of the REIT and not within the REIT itself. This tax transparency also applies in Malaysia, Japan, South Korea and Thailand. Hong Kong stands out on this aspect, as rental income on property held directly by an authorised REIT is subject to either property tax or profits tax at the prevailing rate, depending on the holding structure.

Source: Bloomberg, Dec 2012
Asia as the World’s Growth Engine

As Asia continues on its growth trajectory, the investment case for investing in the region remains focused on the key areas of demographics, urbanisation, rising wealth and strong GDP growth, all of which translate into positive momentum for the Asian property market and Asian REITs.

The demographics are certainly compelling. Asia is home to more than 60% of the world’s population and includes the two most populous countries, China and India, who have the largest number of people in the working age group. That is currently more than a billion people in China and around 700 million people in India. Across the ASEAN block, the working-age population is expected to continue to grow until the 2040s.

Many of these workers are moving to cities to get better jobs and more pay – this trend of urbanisation, leading to rising levels of wealth in Asia, is another key investment case for Asia. According to the United Nations, an extra 1.1 billion people will move from rural areas into Asian cities between 2011 and 2030. As cities extend outwards and new homes are built, demand for residential properties are likely to push rents higher as supply struggles to keep up.

Many of these migrant city workers, with high levels of literacy and education, will look for office jobs and the corresponding higher pay that this accords. Demand for office space is likely to rise, causing rents to rise with it. In addition, higher wages create a change in consumption patterns. As disposable income rises, less of a worker’s salary will go towards food and necessities and more will be available to buy mobile phones, TVs and other forms of entertainment. The beneficiaries of this will be the Asian REITs that invest in shopping malls and other retail complexes, as rising demand for retail space pushes rental yields higher.

Asia’s demographics and urbanisation trends are strong reasons to believe that Asia’s GDP growth trajectory is set to continue. Rising wealth is helping domestic demand to grow, leading to more sustainable sources of GDP growth. As the world’s growth engine, Asia presents a compelling investment case, and Asian REITs is one way to tap into this.
Diversified Income Streams Protect Against Economic Uncertainty

There is a wide range of REITs that holds different types of property. Some may specialise in retail space, for example, while others may invest purely in office blocks. This can help to provide a diversified rental income stream. For example, the return drivers for a shopping mall will depend on consumption patterns, while rents for an office block will rely on employment trends. This is especially important during periods of economic uncertainty, as a more diversified income stream can help to smooth out overall returns.

REIT investments can be used as a proxy for property investments, but have the benefits of being unitised and liquid compared to direct property holdings. As specialised REITs may focus on particular real estate sectors, investors have the flexibility to tailor their holdings and make timely allocations according to the market cycle. This contrasts with direct property holdings which are lumpy and illiquid assets by nature. In addition, the large capital requirement makes it difficult for investors to achieve a sufficient level of diversification without a large amount of capital.

Correlation of different real estate and asset classes

<table>
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<th>Hotels</th>
<th>Industrial</th>
<th>Office</th>
<th>Retail</th>
<th>Residential</th>
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<tr>
<td>Office</td>
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<td>1.00</td>
</tr>
</tbody>
</table>

Note: Correlation calculated using monthly returns from 1990 to present.
Source: UBS estimates, Oct 2012
High Yields and Attractive Total Returns

With yields in recent years reaching as high as 5%-6% combined with long term capital growth, Asian REITs offer attractive total returns, especially in the current low interest rate environment. Over the past 5 years, which includes the global financial crisis, Asian REITs returned around 80%, compared to around 20% for Asian equities. From the lowest point during the global financial crisis, Asian REITs rebounded strongly – to give a return of 325%. This compares favourably to other income producing assets, as US treasuries and other major market government bonds have been offering very little to investors by way of yields.

In addition, the rental income stream from different types of property can provide a hedge against future inflation. Each time the lease on a property is renewed, property owners are able to negotiate and adjust the rent according to inflation levels and other costs. The rental adjustment process can be as frequent as daily, in the case of hotel rooms, or annually, as is typically the case for residential properties. Properties with leases longer than 12 months, such as for offices or government agencies, may have an explicit and automatic adjustment for inflation built into the agreement.


Note: Asia REITs Index refers to S&P Pan Asia Reit Index (ex Japan/AU/NZ, Unhedged, JPY Base, Net, Single stock limit of 10%)
Source: Bloomberg and Nikko Asset Management, Tokyo, Apr 2013
Improved Governance Benefits Investors

Asian REITs have been improving their governance structures in quantifiable areas such as the independence of Board Members, transparency and alignment of managers’ and unitholders’ interests in terms of remuneration, fees and related party transactions and limits on gearing. This helps to ensure that investors are protected from events that may not be in their best interests.

The Asia Pacific Real Estate Association (APREA), the trade body for the Asian real estate community, recently introduced a new measure of corporate governance for Singapore REITs in 2012. The R-Index of Corporate Governance sets out the framework for good governance structures and scores REITs on 27 factors covering external and internal corporate governance. Scores of up to 100% can be secured, with 100% being the top score.

Source: Datastream, UBS, Apr 2013

REITs Can Improve Risk-Adjusted Returns

From a portfolio efficiency perspective, there is a low to negative correlation between REITs and bonds and a medium correlation between REITs and equities. This means that investing in REITs as part of a diversified portfolio can improve risk-adjusted returns.
The beta of Asian REITs has returned to normalised levels of around 0.5 for Singapore and 0.2 for Hong Kong. This presents an opportunity for investors to tap into the low volatility, more defensive nature of REITs compared to equities.

Source: Datastream, UBS, Apr 2013
INVESTING IN ASIAN REITS PRE- AND POST-CRISIS

The global financial crisis was a watershed event for Asian REIT investors in several important aspects. First, in the midst of extreme financial stress, investors were compelled to re-examine whether REITs remained relevant in their portfolios. Asian REITs had to make difficult decisions in order to survive the crisis and undertake bold changes to become more resilient in future. Lastly, Asian REIT regulators were made to examine their respective REIT frameworks, especially with regard to corporate governance safeguards.

Post-crisis Investors Demand Much More

Before the financial crisis, Asian REITs had grown in prominence since their creation around the year 2002. During the pre-crisis period, investors focused mainly on asset strategies when evaluating the investment merits of Asian REITs. REITs that had strong property management skills, such as tenant mixing and executing asset enhancement initiatives, were highly regarded. Also sought after was the ability to make accretive acquisitions by taking advantage of the spread between asset and funding yields.

Following the financial crisis, investors in Asian REITs have become more demanding. Asset strategies remain important, but investors are now alert to the importance of a well-considered funding strategy. Investors want to see REITs having debt portfolios that are well diversified by expiry, lender and debt type. They also want to see prudent gearing levels. To a large extent, Asian REITs have responded to this demand, resulting in more resilient debt profiles.

Post-crisis investors also require that Asian REITs take a more active stance in managing their cost of equity. These investors look for REIT managers that treat REIT equity as a valuable commodity. Well regarded REIT managers recognise the advantages afforded by a low cost of equity and have credible strategies in place to achieve this. In making acquisitions, these managers also display sensitivity to the value of the equity they may issue and its impact on returns to unitholders.

In addition, investors are now more sensitive to differences in corporate governance among Asian REITs. While they may demand that regulatory authorities take steps to enhance governance safeguards, astute investors recognise that the best way to assess a REIT’s corporate governance credentials is getting to know the managers of individual REITs and their past track records.

In this section, Lai Yeu Huan, portfolio manager at Nikko Asset Management Asia Limited, and expert on Asian real estate including Asian REITs, discusses the implications of investing in Asian REITs following the global financial crisis.
Asian REITs and the Quest For Yield

A key feature of the post-crisis investment landscape is the ultra-low interest rates experienced world-wide, a result of stimulative monetary policies among the major global economies. In such an environment and with risk appetite still lukewarm, investors have gravitated towards income-producing investments, including Asian REITs. Since early 2012, Asian REIT yields have compressed appreciably, as their stable income-producing characteristics became increasingly sought after.

Our opinion is that there is room for Asian REIT yields to compress further, albeit much more modestly than in 2012. Demand for Asian REITs remains well supported, in our view, as investors continue to seek alternatives to ultra-low interest rates. Despite the compression we have already witnessed, Asian REIT yields remain elevated when compared against prevailing long bond yields. With inflation potentially making a comeback, Asian REITs are also well placed to offer investors a hedge, as discussed earlier in this paper.

Lastly, we expect Asian REIT yields to compress modestly due to stronger growth expectations. This is primarily driven by a continued recovery in economic activity. In addition, Asian REITs are now able to access growth via acquisitions again, with both equity and debt funding costs having fallen to workable levels. More importantly, both equity and debt providers are now open to supporting Asian REITs with capital for acquisitions.

Renaissance In Progress

With important lessons learnt following the global financial crisis, increasingly sophisticated investor demands, and sufficient depth and breadth, we believe that Asian REITs are well-placed to form a core part of investors’ portfolios. Asian REITs are likely to continue providing steady returns, with yields that still exceed long bond yields by a healthy margin and are expected to compress modestly going forward. Lastly, more abundant growth opportunities make the sector a fertile ground for careful security selection, in our opinion.
Nikko Asset Management Asia Limited (Nikko AM Asia) combines the strengths of two award-winning asset managers, the former DBS Asset Management and Nikko AM Singapore. We manage a wide range of Asia Pacific ex-Japan equity mandates, including regional Asia and single country portfolios, and Asian fixed income solutions including Asian local currency, credit, short duration and passive strategies.

Established in Singapore since 1982, Nikko AM Asia is part of the Nikko Asset Management group (Nikko AM), the largest regional asset management company headquartered in Asia with total AUM of US$154 billion and one of the largest distributor networks across the Asia-Pacific region, comprising over 300 banks, brokers, IFAs and life insurance companies.

As fundamental and long-term investors in Asia, our proprietary research capabilities provide innovative funds for our clients. Our Asia Pacific ex-Japan equity investment team comprises 7 portfolio managers and 5 analysts based in Singapore, with an average industry experience of 13 years. They are supported by counterparts in Australia, China, India, Japan and Malaysia for further insight on macro and sector analysis within each market.

**REITs @ Nikko AM**

Nikko AM Asia was an early entrant in the REIT market, launching the Nikko AM Shenton Global Property Securities Fund in 2005 in Singapore. Currently, Nikko AM Asia manages the Asia Pacific ex-Japan portion of the fund. This was followed by an Asian REIT fund, launched by Nikko AM in Japan in 2007. The fund did particularly well and outperformed in 2009, leading to an overall excess return of around 24% above its benchmark, the S&P Pan Asia Reit Index (ex Japan/AU/NZ, Unhedged, JPY Base, Net, Single stock limit of 10%). More recently in 2010, Nikko AM Asia was appointed as a sub-manager of an Asia Pacific ex-Japan Real Estate Fund for a Korean client and awarded a Singapore REIT mandate by a Singapore institutional client.

Lai Yeu Huan, who heads the equity research team, is the resident expert on Asian real estate including Asian REITs. He has researched Asian REITs since 2003, about the time the market started to take off. Prior to joining Nikko AM Asia in 2008, he covered Asian real estate and Asian REITs at Lion Global Investors and with the independent equity research team at Standard & Poor’s. Lai has also authored valuation reports on REITs and presented widely on both the REIT sector and its valuation methodologies.

The Nikko AM Shenton Global Property Securities Fund, managed by Lai, was recently named ‘Best Fund over 3 years’ in the Equity Sector Real Estate Holdings Global category by The Edge – Lipper Awards 2013.

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1 Consolidated assets under management and advice of Nikko AM and its subsidiaries as at 31 December 2012. “Largest” based on AUM sourced from Asia, including Australia and New Zealand, using third party published AUM figures as of June 30, 2012. “Regional” excludes firms with more than 75% of AUM sourced from a single country.
### Investment Philosophy

We aim to deliver consistent returns that are commensurate with the risk profile of each portfolio. Specifically for REITs, we believe that long term shareholder returns are ultimately derived from rental income and dividend yield. Thus, we only invest in **fundamentally sound REITs with identifiable competitive advantages** to ensure that rental income can be sustained to drive **capital appreciation** and **dividend returns**. In this regard, we look for factors that will drive rental growth as this will ultimately propel income appreciation. We favour REITs which have a track record of returning steady dividend yields to shareholders.

With respect to managing risks, we avoid REITs without proper corporate governance and we seek to ensure that there are sufficient valuation buffers to the REITs that we do hold. In addition, we employ risk analytics to help manage portfolio volatility.

2 Capital appreciation and dividend returns are not guaranteed. Investments are subject to investment risks, including the possible loss of principal amount invested.

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### Important Information:

This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. Any securities mentioned herein are for illustration purposes only and should not be construed as a recommendation for investment. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Investments in unit trusts are not deposits in, obligations of, or guaranteed or insured by Nikko Asset Management Asia Limited (“Nikko AM Asia”).

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