RESEARCH

GLOBAL CAPITAL MARKETS

Q1 2015

JAPANESE PENSION FUNDS | OPPORTUNITIES & RISKS | OUTLOOK

KEY FACTORS PUSHING JAPANESE PENSION FUNDS IN TO RISKIER ASSETS

Government pressure to invest to help economic growth

Diversification by geography and sector

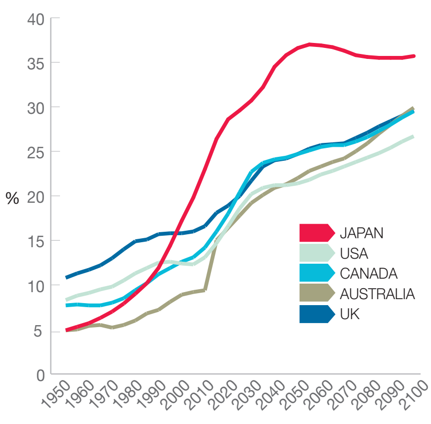
Low bond yields which are likely to rise

Inability of ageing workforce to support pensioners

FIGURE 1
Japanese 10-year bonds

Source: Macrobond

FIGURE 2
% of over 65s in the population



Source: United Nations

JAPANESE PENSION FUNDS POISED FOR DRIVE INTO GLOBAL REAL ESTATE

Against a backdrop of a weak economy and persistent low inflation, Japanese pension funds are gradually shifting away from low-yielding fixed income assets such as government bonds, which have historically been the mainstay of their portfolios.

While a major change in strategy is unlikely in the short term, some of the bigger funds are expected to significantly increase their exposure to global real estate over the coming years. In fact, the sheer size and scale of a number of these funds will likely mean that they become some of the world's largest property investors, potentially dwarfing some of the current leading players.

Economics aside, the impetus for the move into global real estate comes from a number of factors, not least because of the problem of underfunded pensions, which is partly the result of an ageing population and a lack of diversification.

Japan is the most rapidly ageing country in the developed world. Many post-war "baby boomers" are now reaching retirement, increasing the need for pension provision and putting existing funds under pressure, with a growing problem of payouts exceeding contributions.

In 2013, Japan's population declined for the third successive year, reaching 127.3 million, while the proportion of over 65s now exceeds 25% and the birthrate remains one of the lowest in the world. With further population decline expected, the country's ability to support its elderly through health and social services will become even more challenging.

The government has therefore been pushing for an overhaul of the structure and governance of the country's largest pension fund, GPIF, which manages Yen 127 trillion (US$1.3 trillion) of public pension money. As part of this process, GPIF is set to increase its allocation of capital to riskier assets, including domestic and overseas equities, as well as greater exposure to alternative investments such as real estate.

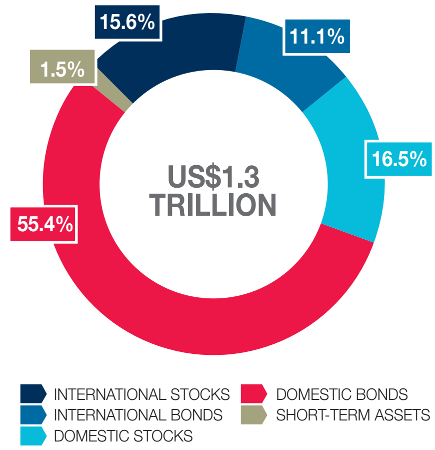
The new strategy is expected to involve a reduction in its holdings of low-yielding Japanese government bonds, with the scale of the anticipated changes likely to result in downward pressure on the Yen over the medium term. The deflationary environment has enhanced the real return

FIGURE 3 **Japan's leading pension funds**

Pension fund name	Total assets (US$ mn)
Government Pension Investment Fund	1,292,003
Local Government Officials	201,443
Pension Fund Association	119,199
National Public Service	93,149
Public School Employees	67,976
Organization for Workers	54,788
Private Schools Employees	40,611
National Pension Association	28,843
Mitsubishi UFJ Financial	25,282
Nippon Telegraph & Telephone	24,388
Panasonic	21,269
Mizuho Financial Group	17,462
Zenkoku Shinyo Kinko	17,153
Hitachi	16,365
Toyota Motor	12,585
Fujitsu	12,334
Sumitomo Mitsui Financial Group	11,960
Total assets (US$ mn)	**2,056,810**

Source: Pensions & Investments/Towers Watson 300 Ranking, 2013

FIGURE 4
GPIF asset allocation at the end of 2013 financial year



Source: GPIF

from bonds, but the expected rise in inflation is likely fuel investor demand for higher-yielding assets.

It is difficult to gauge how quickly the diversification will occur but, initially, GPIF is expected to invest more heavily in Japanese equities, followed by overseas shares. Allocations to real estate should also increase in the next 1-2 years, initially in the domestic market.

As with other investors with limited experience in global property markets, the first wave of international investment is likely to focus on the larger gateway cities such as London, New York, Paris and Frankfurt. These cities have the most mature property markets, along with transparency, liquidity and a range of trophy buildings typically acquired by large global investors.

To-date, the shift into riskier assets has been relatively modest but the trend is clearly underway and real estate will feature increasingly on pension funds' radar. With the top 15 Japanese pension funds managing over US$2 trillion between them – including US$1.3 trillion by GPIF alone – even a small allocation to property is likely to have a significant impact on global real estate markets.

Just a 5% allocation to international property by the fifteen largest Japanese pension funds would amount to US$100 billion. This is unlikely to occur overnight, but could well have a major impact over the next 3-5 years.

BROKER SURVEY

A survey of leading Japanese investment brokers from Sumitomo Mitsui Trust Bank

Knight Frank/SMTB undertook a survey of leading SMTB brokers to establish their views on how the large Japanese pension funds might approach the real estate market over the next 1-2 years. The questionnaire focused on issues such as their allocations to real estate, their anticipated geographic and sector focus and their key reasons for investing in property.

Key findings

- A significant majority expect Japanese pension funds to slightly or moderately increase their exposure to real estate. Just over half expect a slight increase and around a third expect a moderate increase in pension fund allocations to property.
- A clear majority also believe that funds which increase their exposure to property will focus initially on the domestic property market rather than international markets.
- Most brokers believe that pension funds' preferred routes will be via funds and REITs rather than direct property acquisitions.
- Offices will be the most popular sector, followed by residential – the sectors with which they are most familiar. Hotels and specialist property will be the least preferred sectors.
- Most say that the key attraction of property for Japanese pension funds is income stability, followed by the opportunity to diversify.
- Nearly 70% of brokers believe that North America will be the most popular region for Japanese pension funds investing abroad, with other Asian markets and Europe trailing behind.
- At a country level, the US is expected to be the clear number one choice for Japanese pension funds investing in international real estate, followed by the UK. Germany and France also featured, as did Australia, India, Indonesia, Malaysia and Singapore among Asian markets.

FIGURE 5 **Will Japanese pension funds increase their allocations to real estate in the next 1-2 years?**

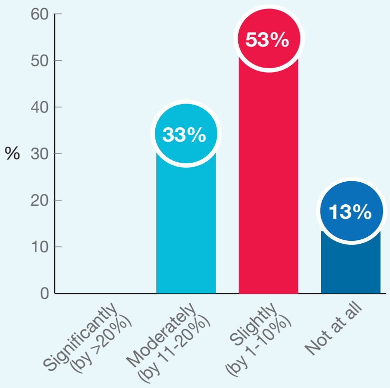


FIGURE 6 **Main attraction of real estate for Japanese pension funds (ranked by popularity)**

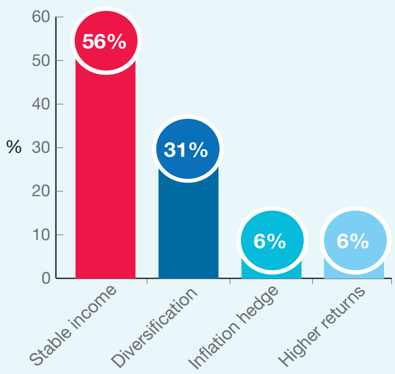
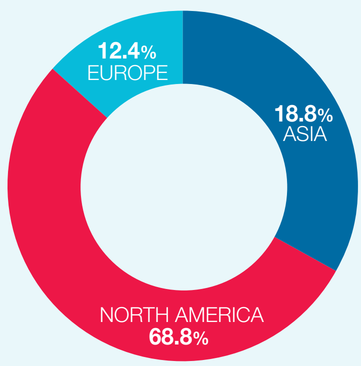


FIGURE 7 **Preferred target regions for Japanese pension funds investing in international real estate (ranked by popularity)**



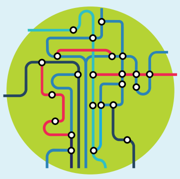
Source: SMTB / Knight Frank Research

GLOBAL REAL ESTATE OPPORTUNITIES & RISKS IN 2015

Knight Frank's commercial research team continuously monitors trends in global real estate markets and has analysed the major opportunities and risks for investors in 2015. For each factor, we have provided a short summary and an assessment as to the likelihood of it happening and its potential impact on the property market.

We have used a simple grading of high or low for both probability and impact.

INFRASTRUCTURE



Governments around the world are investing billions in urban infrastructure as they recognise its importance for our economic and social fabric, particularly the buildings where we live, work and play. High quality infrastructure, economic growth and the creation of real estate opportunities go hand in hand. Noteworthy forthcoming projects include the Grand Paris Express and the Beijing Capital Second International Airport.

PROBABILITY: High **IMPACT:** High

DEVELOPMENT

Development activity is accelerating across all property sectors and will feature increasingly on investors' radars in 2015. In part this reflects the weight of capital chasing stock, with many investors finding it difficult to access "value" opportunities. The recent lack of development is leading to a falling supply of good quality office space, particularly in CBDs in the gateway cities

PROBABILITY: High **IMPACT:** High

OCCUPATIONAL MARKET RECOVERY

Some of the best investment opportunities lie in the continuing economic recovery and, with it, a rebound in occupier activity. The US has seen the strongest occupational recovery, with Europe lagging because of economic weakness and high supply holding back rents in Asia Pacific. However, growing demand and falling availability will lead to supply constraints in the next 6-12 months – pushing up rents in many major cities.

PROBABILITY: High **IMPACT:** High

SPECIALIST INVESTMENTS

"Specialist" property continues to attract investor interest and offers significant opportunities. All mainstream sectors start life as "specialist" before becoming a viable asset class, a trend which can take years but one which has helped the property universe to expand. Out-of-town retail now features strongly in investor portfolios and student accommodation, healthcare and car parks are becoming increasingly popular.

PROBABILITY: High **IMPACT:** Low

EUROPEAN RECOVERY

Europe's economy remains fragile, but the commercial property market is recovering and is set to see further gains in 2015. Perhaps the most encouraging trend is the rebound in Ireland and parts of Southern Europe. A buoyant investment market has led to yield compression in many areas and, with rents generally below their pre-recession peaks, activity should receive a further boost in 2015.

PROBABILITY: Low **IMPACT:** High

EVENTS

"Events", which range from military conflicts such as Ukraine and the Middle East, to volcanic eruptions and the recent Ebola outbreak, can have a significant impact on investor sentiment. Some events have a direct economic impact on trade and travel, while others just add to the existing uncertainty.

PROBABILITY: ↑ **IMPACT:** ↓

POLITICAL & SOCIAL INSTABILITY

A major issue for investors has been social and political instability, which may persist in 2015 if the economic recovery falters. Europe has high unemployment rates, while a number of developing countries have seen serious protests against corruption and lack of democratic accountability. A prolonged period of low oil prices may lead to further instability in some countries in 2015.

PROBABILITY: ↑ **IMPACT:** ↓

CENTRAL BANK POLICY TIGHTENING

The direction of central bank policy remains critical to the still fragile global economy and many investors were concerned that monetary policy would begin to tighten in 2015. However, throughout 2014, it became clear that monetary policy around the world is likely to remain relaxed for the foreseeable future, notably in Europe where key interest rates are close to zero or even negative.

PROBABILITY: ↓ **IMPACT:** ↑

CHINA SLOWDOWN

A possible hard landing for the Chinese economy – a major driver of global growth – would impact significantly on many parts of the world. However, arguably, the pace of Chinese growth has been falling for several years and, in any case, China is rebalancing to become more focused on consumption – a trend which will benefit other exporting nations.

PROBABILITY: ↓ **IMPACT:** ↓

DEFLATION

The threat of deflation applies mainly to Europe, with some countries now seeing steady month-on-month price falls. However, Europe will likely see a further period of low inflation rather than outright deflation. While demand has been weak, lower prices have in fact been caused mainly by falling food and energy costs, rather than consumers delaying purchases because they believe prices may fall.

PROBABILITY: ↓ **IMPACT:** ↑

KEY FINDINGS

Global transaction volumes to reach US$700bn in 2015

Declining availability to drive rental growth

Increasing investor interest in smaller cities

New wave of Chinese capital emerging

Investors looking at development to drive returns

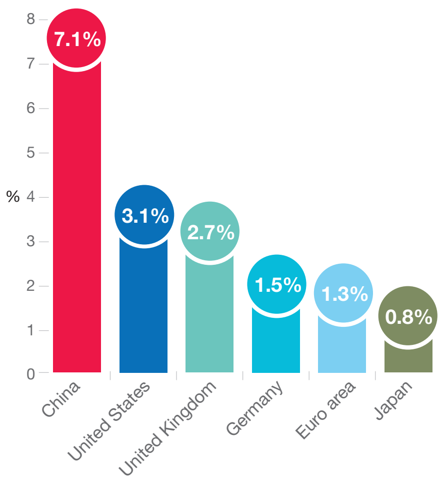
Prime office capital values vary significantly around the world

OUTLOOK

Economic forecasts for 2015 are slightly less positive than six months ago, as the global recovery remains uncertain and uneven.

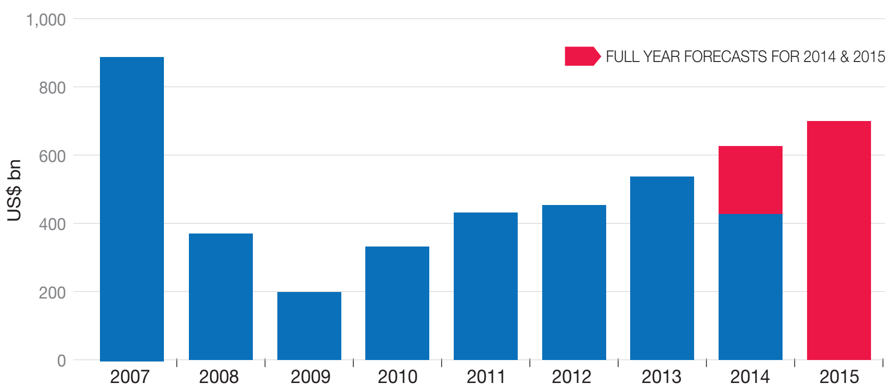
- The main engine of growth will be the US, while China's expansion is forecast to moderate. Weakness will persist in the Euro area, Japan and some emerging markets.
- Global interest rates will rise at some point, but the recent soft economic data – particularly in Europe – will delay the process. In fact, rates in the Euro area have recently been cut to aid the fragile recovery and to boost lending.
- With perhaps the exception of the US, the likelihood of interest rate rises in 2015 has therefore receded. Interest rates will remain lower for longer and increases are likely to be gradual.
- Occupier markets will tend to mirror economic trends in 2015. However, tenant demand for prime commercial space is generally improving, led by offices and logistics. Falling availability will lead to supply constraints in major global cities, helping to drive rental growth.

FIGURE 1
GDP Growth Forecasts for 2015



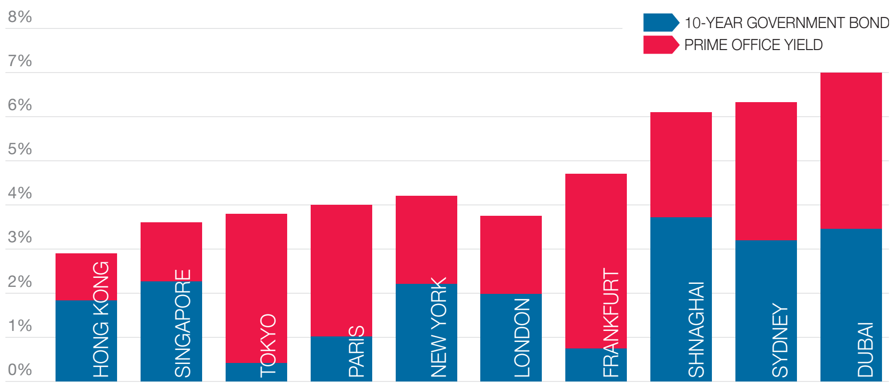
Source: IMF (October 2014)

FIGURE 2
Global commercial volumes (US$ bn)



Source: Real Capital Analytics, Knight Frank Research
Data relates to commercial property only and excludes apartments and development sites. Data correct as at Q3 2014

FIGURE 3
Prime office yields and government bonds

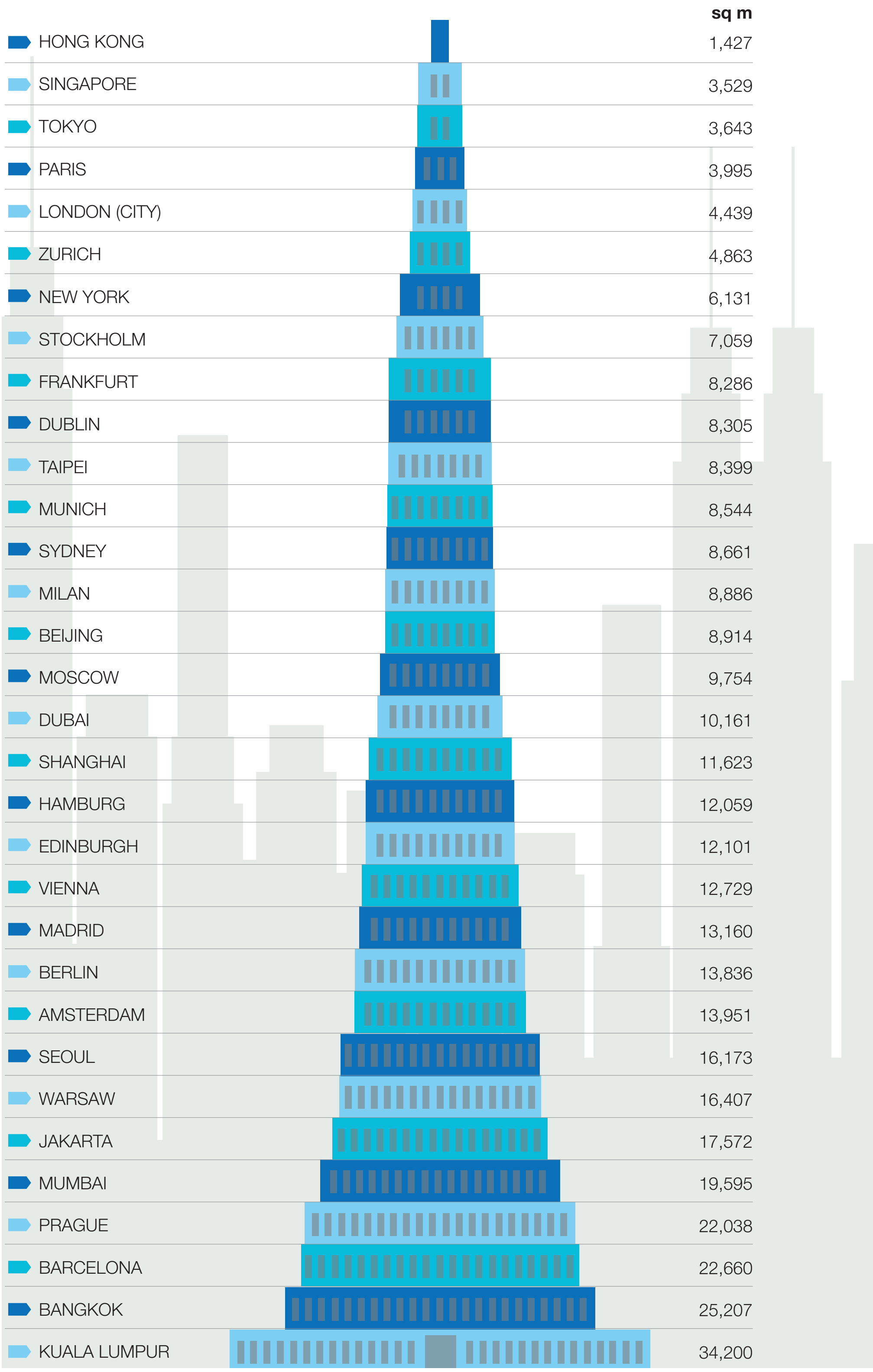


Source: Knight Frank Research / Trading Economics
Data correct as at December 2014

- Real estate capital markets have been increasingly buoyant and disconnected from occupational trends. Globally, transaction volumes for the first nine months of 2014 were US$427bn – comfortably ahead of 2013 – with Europe and the US in particular seeing strong growth.
- The finalised data are expected to show that global investment volumes for commercial property exceeded US$600bn in 2014, circa 15% up on 2013. Our forecast for 2015 is for at least another 10% rise to over US$700bn, given the significant weight of capital targeting real estate.
- Investors' focus has been on transparency and liquidity, which has played to the gateway cities. However, demand is increasing for second and third tier cities where competition for stock is less intense and potential returns are higher.
- Cross-border investment will continue to grow, as investors seek better returns and diversification outside home markets. Partnerships between overseas and domestic players - which provide a powerful combination of capital and local market knowledge - will be increasingly common.
- A new wave of outbound Chinese capital is also emerging, comprising mainly ultra-high net worth Individuals (UHNWIs), small- to mid-cap state owned enterprises (SOEs) and private developers.
- With domestic investors increasingly active again, competition for stock will intensify in 2015. As a result, a corporate acquisition may provide a quicker and easier solution for some buyers. Development is also accelerating which reflects greater risk tolerance, as well the need for new stock.
- Areas of real estate currently perceived as "specialist" such as healthcare and student housing will feature increasingly in 2015, as the search for higher returns continues and new sectors become more familiar.

FIGURE 4

How much prime office space does US$100m buy?



Source: Knight Frank Research

The diagram above shows the 'theoretical' amount of prime office space that can be purchased for US$100m in each of the cities listed. The analysis is based on implied hypothetical capital values calculated from the prime rent and yield in each market. Please note that the figures are indicative only and are not related to any specific building or transaction.

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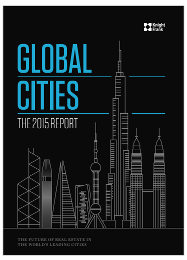

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