Catalyst for Change

Commercial Real Estate
Private Credit in Asia Pacific

August 2023
Market inefficiencies exacerbated by regulatory changes and the current tight financing environment will continue to fuel the growth of the Asia Pacific Commercial Real Estate Private Credit market.

From Margins to Mainstream: Private Credit’s Rise as an Asset Class

Private credit in commercial real estate (CRE) has become an essential component of an investment portfolio in the prevailing economic environment, exacerbated by tighter liquidity and elevated interest rates. Traditional lending institutions have become cautious in an increasingly restrictive regulatory environment and private credit has filled the void by offering creative capital solutions to businesses and individuals.

ACCESS AND FLEXIBILITY ARE CRUCIAL

Borrowers increasingly prioritise access and flexible terms covering liquidity and repayment over headline interest rates. Capital constraints and tightening regulatory regimes are weighing on traditional lenders, driving businesses and individuals towards alternative financing sources. Growing capital gaps, with a multi-year low in Loan-to-Value (LTV) limits and the highest mortgage rates since the global financial crisis, have further accelerated this shift.

In this evolving landscape, private credit has emerged as a vital solution, providing tailored financing options which meet the evolving needs of borrowers in the current challenging macroeconomic and capital market environments.

Simultaneously, private credit in CRE is gaining recognition as an important asset class and is an appealing option within institutional investor portfolios, functioning as a hedge or complement to existing exposures. Its unique investment characteristics, including potentially higher yields, downside protection, and reduced susceptibility to market volatility, make it an attractive asset class for diversification and enhanced risk-adjusted returns.

Especially within the Asia Pacific region (APAC), Australia stands out as a compelling market (refer to case study on page 5), distinguishing itself among other noteworthy destinations such as South Korea (S.Korea), Japan, India and China.

1. Introducing The World of CRE Private Credit

THE CRE PRIVATE CREDIT UNIVERSE

The global private credit market has experienced tremendous growth in the past five years, more than doubling in size.

CRE private credit strategies can be classified into two broad categories:

1. **Core**: Investors in this category receive regular and predictable cash flows, according to the agreed contractual terms. Interest payments are backed by income-producing and core development collateral;

![Figure 1: Summary of CRE Private Credit Strategies](source: Alternative Credit Council, CLI Group Research, August 2023)

- **DIRECT LENDING**: Distribution of current income derived from investments throughout their terms
- **STRUCTURED CREDIT**: Variety of fixed-income products to provide some capital protection and capital appreciation
- **DISTRESSED FUNDS**: Deeply discounted debt securities from middle-to-large capitalisation companies, with returns generated from restructuring or negotiations

Source: Alternative Credit Council, CLI Group Research, August 2023

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1. **MEZZANINE FUNDS**: Debt instruments that are subordinate to senior / working capital facilities, but rank above equity
2. **SPECIAL SITUATIONS**: Value lending opportunities brought on by specific events (e.g. lack of liquidity, shareholder disputes, corporate rescue or refinancing)
3. **DISLOCATION FUNDS**: Financing opportunities that seek to take advantage of dislocation and inefficiencies in markets

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1. LTV for commercial assets were only slightly over 50% in May 2023 (Dec’19: 66%), the lowest since end-2009 – using transactions in the US as a benchmark. In APAC, average LTV ratios declined to 55% from 60% in South Korea, and to 50% from 55% in Australia, over the past 24 months. Source: MSCI, CBRE, May 2023.
2. Commercial mortgage rates experienced spikes in 2022 and rose to 6.7% in May 2023 (Dec’19: 3.9%), the highest since mid-2010 (prior to 2020) – using transactions in the US as a benchmark. The cost of debt has increased across the board in APAC, from 2-3% to 5.5-6.0% over the past 24 months. Source: MSCI, CBRE, May 2023.
3. Total Private Debt Assets under Management (AUM) grew 137% from end-2017 to US$1.47 trillion in end-2022, of which 46% is allocated within Direct Lending. Source: Preqin.
2. **Opportunistic**: Investors in opportunistic strategies are exposed to **distressed borrowers** who are struggling to meet financial obligations. The purpose is to **gain control and increase the value** of debt (such as through operational restructuring or negotiations) and further explore upside via equity ownership.

There is a wide range of private credit strategies (Figure 1) under these two categories, each varying in risk-return profiles (Figure 2), levels of seniority and structural features. When making decisions in this space, investors should carefully consider these strategies based on their specific investment goals, time horizon, risk tolerance and inherent characteristics.

**Direct Lending** is the most popular strategy within the Core category, with close to half of the global private credit market currently allocated within this area, because it is the most straightforward and can plug the credit gap directly. Direct Lending is very much relationship-based and enables lenders to develop a more nuanced understanding of borrowers’ business and financial positions, thereby facilitating enhanced support beyond capital provision. Another strategy within the Core category is **Structured Credit**, which includes fixed-income like products and products with additional upside.

**Direct Lending is the Preferred Strategy in APAC**

In the rapidly evolving APAC private credit space, Direct Lending stands out as the preferred strategy for institutional investors. It allows them to navigate and gain familiarity with the diverse jurisdictions across the region without having to move up the risk curve to establish relationships with relevant managers and local networks.

On the other end of the spectrum, the Opportunistic category includes Distressed Funds, Dislocation Funds and Special Situations. **Distressed Funds** are more company-specific, where the corporate debt is trading at a heavy discount and holders are looking to generate returns from restructuring or asset sales, whereas **Dislocation Funds** serve to capitalise on significant and temporary disruptions in the broader real estate market. **Special Situations** funds share similarities with Distressed and Dislocation Funds in that they focus on value opportunities arising from specific events such as shareholder disputes and corporate refinancing, although these may not necessarily involve discounted bonds.

**Mezzanine Funds** cut across both the Core and Opportunistic categories. They are broader in their investment approach but are unique in their level of seniority, where they rank above equity but below that of senior or working capital facilities in the capital structure.

### HOW DO THE RISK-REWARD RATIOS OF THESE STRATEGIES STACK UP?

**Lowest Risk: Direct Lending**

Direct Lending is positioned at the lowest end of the risk spectrum and offers attractive unlevered returns. The highest returns within this strategy are typically achieved in emerging markets. The primary objective of this strategy is capital preservation and focuses on providing credit to established borrowers who offer stabilised, income-generating properties or core development properties as collateral.

**Moderate Risk: Structured Credit, Special Situations, Mezzanine Funds**

Strategies such as Structured Credit, Special Situations and Mezzanine Funds, which occupy an intermediate position within the capital structure, fall into the moderate risk category. They offer higher returns than Direct Lending. The increased return potential commensurates with the inherent uncertainties and risks associated with these strategies.

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**Figure 2: CRE Private Credit Local Currency Total Returns Spectrum in APAC – by Strategy**

- **Direct Lending** carries the most balanced risk-adjusted return profile.
- **Structured Credit**, **Special Situations**, and **Mezzanine Funds** are positioned higher on the risk spectrum.
- **Senior Debt** (Senior Bank Loans / Club Senior Loans) is at the lowest risk end.

Source: CLI Group Research, August 2023
Highest Risk: Dislocation Funds, Distressed Funds

These strategies are characterised by their opportunistic nature, compared with other private credit products, and have the potential to offer the highest returns. However, they come with a greater degree of uncertainty as these strategies are contingent on the borrowers’ fundamentals and are associated with downside risks, including the possibility of capital value diminution. Furthermore, successfully implementing these ‘turnaround’ strategies requires a considerable amount of expertise to extract alpha.

Overall, Direct Lending is widely regarded as having the most balanced risk-adjusted return profile among all strategies, primarily due to the following reasons:

1. **Focus On Core Strategies:** This reduces the likelihood of default, contributing to a more stable and predictable stream of income.

2. **Robust Underwriting:** Borrower creditworthiness is heavily prioritised in Direct Lending strategies, where careful evaluation is carried out to only those with reliable financial track records.

3. **Collateralised Nature:** This serves to provide an additional layer of security for lenders of non-recourse loans, increasing the likelihood of recovering the initial investment in the event of a default.

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### 2. The APAC Opportunity – Just Getting Started

#### APAC IS VASTLY UNDERSERVED IN THE PRIVATE CREDIT SPACE

Credit markets in APAC are fragmented due to diverse regulatory and legal regimes as well as local market nuances. These regulation and legal frameworks have continued to promote, and favour established systems within traditional lending, where deal sourcing and origination have been almost exclusive. Compared with its global counterparts, commercial banks still dominate APAC CRE loans, with a market share of 70%, compared to Europe (69%) and the US (54%) (Figure 3).

#### THE PRIVATE CREDIT MARKET IN APAC IS GEARED FOR ACCELERATED GROWTH

However, in recent years, there has been a significant increase in demand for private credit across APAC as traditional lenders have become more cautious and regulatory requirements have tightened. This surge is evident in the rapid expansion of the private credit universe (Figure 4), which is anticipated to persist, underpinned by the region’s emphasis on real asset developments and the growing requirement for alternative capital sources.

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**Figure 3:** CRE Lending by Capital Sources by Region (2018)

<table>
<thead>
<tr>
<th>Region</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>APAC</td>
<td>30%</td>
</tr>
<tr>
<td>Europe</td>
<td>31%</td>
</tr>
<tr>
<td>US</td>
<td>46%</td>
</tr>
<tr>
<td>Other*</td>
<td>70%</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>69%</td>
</tr>
</tbody>
</table>

Source: IMF’s 2021 CRE Report, CLI Group Research, August 2023

* Other refers to commercial mortgage-backed securities, non-bank financial institutions, covered bonds, bad banks, and property company bonds.

**Figure 4:** APAC Total Private Credit AUM and Global Market Share (2010-2022)

Source: Preqin, CLI Group Research, August 2023

APAC’s share of the global pie has historically been single-digit
DISINTERMEDIATION IN APAC IS JUST BEGINNING

Several market forces at play (Figure 5) will continue to push private credit into favour. Previously tightly-held loan books will start to ease into the secondary market as mandatory capital regulations weigh on banks, which are also seeking to diversify portfolio risk.

Several APAC jurisdictions have recently put credit enforcement regimes in place, which will pave the way to increased market access for private credit providers. Other region-specific drivers include the funding gap in the near term, particularly in Australia and S.Korea, as well as the increased institutionalisation of CRE private credit products to serve the under-allocated investor base.

STRATEGIC HOTSPOTS IN APAC FOR CRE PRIVATE CREDIT INVESTMENTS

Australia, S.Korea, Japan, India and China are currently emerging as key markets for CRE private credit strategies, particularly for Direct Lending (Figure 6).

Figure 5: Key Factors which will Underpin Growth of the CRE Private Credit Markets in APAC

- **Banks are Facing Increased Regulatory Limits**: Banks are more willing to offload their loan books and portfolio risk to alternative lenders advancing of private credit markets.
- **Availability of Capital**: Eventual weaning of stimulus packages for the real estate market, coupled with the above increased ongoing need for capital access.
- **Favourable Regulatory Landscape for Private Credit Providers**: Ongoing regulatory changes, including credit enforcement increased market access for private credit providers.
- **Supply-Demand Gap**: Elevated repricing and refinancing risks in the near term driven in part by structurally higher interest rates increased addressable market for private credit providers.
- **Underweight Allocation to Private Credit in APAC**: Further scope for CRE private credit to capture market share of institutional investors looking to increase allocation to this space or to diversify their portfolios.

Source: CLI Group Research, August 2023

Figure 6: Key Country Matrix – CRE Private Credit in APAC

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>S.Korea</th>
<th>Japan</th>
<th>India</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td><em><em>Market Size</em> (US$)</em>*</td>
<td>33 bn</td>
<td>–</td>
<td>14 bn</td>
<td>47 bn</td>
<td>700 bn</td>
</tr>
<tr>
<td><strong>Duration (Direct Lending)</strong></td>
<td>2-4 years</td>
<td>2-4 years</td>
<td>3-5 years</td>
<td>2-3 years</td>
<td>2-3 years</td>
</tr>
<tr>
<td><strong>Loan to Value (LTV)</strong></td>
<td>60%</td>
<td>70%</td>
<td>75%</td>
<td>55%</td>
<td>60%</td>
</tr>
<tr>
<td><strong>Loan to Cost (LTC)</strong></td>
<td>70%</td>
<td>80%</td>
<td>80%</td>
<td>65%</td>
<td>70%</td>
</tr>
<tr>
<td><strong>Preferred Asset Types</strong></td>
<td>Office, Hotel, Logistics, Residential, PBSA*</td>
<td>Office, Retail, Logistics</td>
<td>Office, Logistics</td>
<td>Business Parks, Office, Residential</td>
<td>Logistics, Retail, Business Parks</td>
</tr>
<tr>
<td><strong>Key Drivers</strong></td>
<td>Regulator, Capital Markets</td>
<td>Regulator, Capital Markets</td>
<td>Capital Markets</td>
<td>Growth, Regulator, Capital Markets</td>
<td>Growth, Regulator, Capital Markets</td>
</tr>
</tbody>
</table>

Source: Alternative Credit Council, Plan1, Bloomberg, PwC, EY, Preqin, CLI Group Research, August 2023

* Australia – Estimated funding gap by 2025; Japan – Private credit AUM as of Sept’22; India – Performing Credit based on best case scenario in 2030; China – Includes US$549bn of corporate debt and US$84bn of real estate loan maturity between 2023 and 2027.
# Purpose-built student accommodation.
Key reason being the direct access to market, which would otherwise be challenging for private credit providers. In certain countries – such as India – where private credit providers require a license to lend to domestic borrowers, partnerships are the current way forward. Furthermore, the implementation of reliable enforcement regimes has strengthened private credit markets in the region.

While Direct Lending strategies provide the most balanced risk-adjusted return profile compared with other CRE private credit strategies, investors should note that the APAC private credit environment is still developing. This demands a partner with on-the-ground expertise, experience in navigating market nuances and strong deal-structuring capabilities.

**PROMISING OPPORTUNITY FOR CRE PRIVATE CREDIT**

CRE loans in Australia has experienced a surge in recent times, to AU$375 billion (+10% YoY) in 2022, its largest increase in seven years. At the same time, an estimated AU$50 billion funding gap is emerging (Figure 7), as regulatory pressures progressively weigh on banks and lending requirements tighten, increasing opportunities for the underserved CRE private credit sector, especially in the Direct Lending segment.

Major banks in Australia currently dominate the CRE loan market, accounting for almost two-thirds of the market share. However, it is projected that their dominance will decline to below 60% by 2025. During the same period, private credit providers are forecasted to gain momentum, claiming c.15% (Dec’22: c.10%) of the market share. This notable increase in their influence within the CRE lending landscape can be attributed to the funding gap left by banks, particularly in the acquisition and refinance loan segments.

Private credit has gained traction among investors in Australia seeking higher returns and diversification, driven by a growing emphasis on stable and predictable income streams amidst a market characterised by elevated volatility and uncertainty. With traditional investment options struggling to provide consistent yields, CRE private credit has emerged as an attractive alternative that offers potential risk mitigation.

Moreover, private credit plays an instrumental role in fostering the growth and development of various commercial properties, including offices, hotels, logistics facilities, as well as build-to-rent and purpose-built residential complexes. The flexibility and tailored approach of private credit lending enables it to cater to the specific needs of these diverse real estate ventures.

**POSITIVE UNDERLYING FUNDAMENTALS PROVIDE A FLOOR**

Australia enjoys a stable economic environment and is one of the fastest-growing markets in APAC, demonstrating

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4 APRA, March 2023.
5 Based on CLI Group Research estimates.
6 Major banks comprise the ‘big four banks’ in Australia including ANZ, NAB, CBA and Westpac.
7 Australia’s real GDP growth is forecasted at 1.8% in 2023, higher than the OECD average of 1.4%, and to average 2% to 3% between 2024 and 2027. Source: OECD Economic Outlook, Reserve Bank of Australia, Oxford Economics, EIU, August 2023.
its solid underlying fundamentals and making it an appealing destination for investors and businesses. Australia’s well-developed economic structure, high level of market transparency\(^8\), robust labour market\(^9\), strong population growth\(^10\), as well as added contributions from the ongoing return in international tourism and foreign tertiary students\(^11\), form the basis for this prospect.

The continuous flow of foreign direct investments (FDI)\(^12\) and domestic consumption growth\(^13\) are expected to create a steady demand for modern office spaces. Additionally, as inbound tourism gradually returns, demand for hospitality assets is expected to flow through and retail malls could experience increased footfall and sales given the limited supply of new development projects. The logistics sector is also set to gain from the ongoing shift in retailers’ operating models, as well as the chronic undersupply of modern warehouses\(^14\). Further, the build-to-rent and multifamily sectors are likely to witness rising demand due to limited availability of institutional-grade inventory, coinciding with the recommencement of immigration.

**BALANCED RISK-RETURN PROFILE OF CRE DIRECT LENDING**

Strategies in the Australia CRE private credit space span across core to opportunistic investments that range from stabilised Grade A assets to projects at different phases of construction, and across the capital stack. Investors should consider the distinct risk-return profiles (Figure 8) of these opportunities, including the attendant volatility and duration.

Notably, Direct Lending presents a potential option for investors to achieve attractive risk-adjusted contractual returns with substantial downside protection. The flexible duration of these investment instruments can be a valuable addition to other core strategies, allowing investors to efficiently adjust their portfolio exposure as needed.

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8 Australia is ranked #4 globally in terms of real estate market transparency, the only APAC country within the top five. Source: JLL Global Real Estate Transparency Index 2022.
9 Australia’s unemployment rate was recorded at a multi-decade low of 3.5% in June 2023 and is forecast to remain below the trend level, at between 3.7% and 4.6% over the next five years. Source: EIU, Oxford Economics, August 2023.
10 Australia’s total population growth averaged 1.4% annually from 2012-2022 and is projected to increase at a similar rate of 1.4% per annum between 2023 and 2030. Source: Oxford Economics, August 2023.
11 Education and Tourism were the fourth and fifth largest export contributors, respectively, and together they accounted for 16.4% of total exports in 2019. Source: Australia’s Department of Foreign Affairs and Trade, August 2023.
13 Nominal private consumption in Australia is expected to rise at an average annual rate of 5.9% (2012-2022: 3.9%) to reach AU$2.0 trillion in 2030. Source: Oxford Economics, August 2023.
14 Vacancy rates for industrial warehouses stood at 0.2% and 1.1% in Sydney and Melbourne, respectively, as of 2Q 2023, with new supply representing just 1.0% and 0.3% of total inventory. Source: CBRE, August 2023.
3. How The Private Credit Landscape in APAC will Evolve

THE MARKET WILL BECOME MORE INSTITUTIONALISED

The CRE private credit market in APAC is still in its infancy stage and lacks products such as commercial mortgage-backed securities and mortgage real estate investment trusts, which are prevalent in other regions, particularly in the US.

With interest rates on the rise in key cities across APAC (Figure 9), coupled with anticipated higher structural rates going forward, there is a growing need for alternative financing options in the region.

Further, the challenging financing environment both from the supply side (regulatory pressure on commercial banks) and the demand side (operational decay and working capital constraints) calls for creative capital solutions to address a funding gap caused by more than the increase in base interest rates.

WHY INVESTORS LOOK TOWARDS APAC PRIVATE CREDIT

- **Potential Diversification Benefits from CRE Private Credit Exposure**
  - In tandem with the institutionalisation of the CRE private credit market, allocations to this sector will become more mainstream and made more accessible with advancements in the CRE sector. Investors looking to add private credit to their portfolios can look towards a wider cyclical opportunity set with credit capability, which could enhance risk-adjusted returns.
  - In addition, sustainability is a pervasive consideration, which extends throughout the various layers of capital allocation. When it comes to credit, investors will be inclined to enhance their involvement in this realm.

- **Product Liquidity:** Investors should carefully assess the liquidity terms and provisions of the investments, considering their own liquidity needs and investment horizon. Adequate diversification within the private credit space, as well as across other asset classes, can help manage liquidity risks effectively.

- **Diverse Jurisdictions Demand Local Deal Access and Experience:**
  - Given the highly disparate regulatory environment across cities in APAC, gaining direct access into this emerging asset class will continue to pose a hurdle. Aside from market entry, capital preservation is key to safeguard and unlock investments in the more opportunistic strategies or in the event of default.

Therefore, investment managers, with the necessary local connections, partnerships, and extensive expertise in deal structuring, play a vital role in executing these strategies successfully while fostering relationships with the relevant domestic regulatory entities.

While the APAC CRE private credit market is still in its early stages, the implementation of consistent due diligence and credit enforcement systems has created opportunities for further expansion. This growth is supported by the existing demand-supply gap and the relatively low allocation to private credit in the APAC region.

**Figure 9: Global Benchmark Interest Rates (December 2021 to August 2023)**

![Interest Rates Chart]

<table>
<thead>
<tr>
<th>Country</th>
<th>2021 Q4</th>
<th>2022 Q4</th>
<th>Current - Aug 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>4.25</td>
<td>4.25</td>
<td>4.25</td>
</tr>
<tr>
<td>Europe</td>
<td>4.10</td>
<td>4.10</td>
<td>4.10</td>
</tr>
<tr>
<td>Australia</td>
<td>3.67</td>
<td>3.67</td>
<td>3.67</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.50</td>
<td>3.50</td>
<td>3.50</td>
</tr>
<tr>
<td>India</td>
<td>4.00</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.10</td>
<td>-0.10</td>
<td>-0.10</td>
</tr>
<tr>
<td>China</td>
<td>2.50</td>
<td>2.50</td>
<td>2.50</td>
</tr>
</tbody>
</table>

Source: Oxford Economics, Bloomberg, CLI Group Research, August 2023
* As of 1 August 2023.

**HOWEVER, INVESTORS HAVE TO BE MINDFUL DESPITE TAILWINDS**

- **Considerations include:**
  - **Assessing the Risk-Return Profile:** It is essential to evaluate individual deals based on their underlying credit quality, collateral and borrower strength to gain a thorough understanding of the risk-return dynamics.
  - **Market and Sector Risks:** Deal performance can be influenced by specific broader market demand/supply and city/sector dynamics. Investors should have a good understanding of these micro-factors, which may affect the creditworthiness of borrowers and the value of the underlying assets.
  - **Lack of Transparency in Bilateral Lending:** Private credit bilateral lending agreements may not be subject to the same level of scrutiny and disclosure as those with traditional lenders, which can make it challenging to assess the terms, conditions, and potential risks.

**4. How The Private Credit Landscape in APAC will Evolve**

While the APAC CRE private credit market is still in its early stages, the implementation of consistent due diligence and credit enforcement systems has created opportunities for further expansion. This growth is supported by the existing demand-supply gap and the relatively low allocation to private credit in the APAC region.

15 US Federal Funds Rate, European Central Bank Main Refi Rate, Reserve Bank of Australia Cash Rate, Singapore Overnight Rate Average (3-month compounded), Bank of Korea Base Rate, Reserve Bank of India Policy Repo Rate, Bank of Japan Key Policy Rate and People’s Bank of China 1-yr Medium Term Lending Facility Rate.
Headquartered and listed in Singapore, CapitaLand Investment Limited (CLI) is a leading global real estate investment manager (REIM) with a strong Asia foothold.

As at 30 June 2023, CLI had S$134 billion of real estate assets under management, and S$89 billion of real estate funds under management (FUM) held via six listed real estate investment trusts and business trusts, and more than 30 private vehicles across Asia Pacific, Europe and USA. Its diversified real estate asset classes cover retail, office, lodging, business parks, industrial, logistics and data centres.

CLI aims to scale its FUM and fee-related earnings through fund management, lodging management and its full stack of operating capabilities, and maintain effective capital management. As the investment management arm of CapitaLand Group, CLI has access to the development capabilities of and pipeline investment opportunities from CapitaLand’s development arm.

As a responsible company, CLI places sustainability at the core of what it does and has committed to achieve Net Zero emissions for scope 1 and 2 by 2050. CLI contributes to the environmental and social well-being of the communities where it operates, as it delivers longterm economic value to its stakeholders.
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