SHOULD INVESTORS SEEK ABOVE-AVERAGE PROPERTY RETURNS?

BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world

OUR OVERALL REAL-ESTATE STRATEGY

A substantial compression in gross initial prime yields over the last five years, coupled with the prospect of rising interest rates, is casting a cloud of uncertainty over property markets, commercial and residential alike. However, many property markets performed remarkably well in 2017. Even though key factors, such as interest rates, introduced a degree of ambiguity into the real-estate universe in 2017, many commercial and residential markets enjoyed another stable (or strong) year.

PROPERTY PERFORMANCE MATCHED OR SURPASSED OUR EXPECTATIONS FOR MOST REAL-ESTATE AREAS

REAL-ESTATE DRIVERS IN 2017

INTEREST RATES

Interest rates continued to underpin property markets, which surprised as much as terrified observers. Table 1 shows that nominal long-term government bond rates barely changed in the three-month period to 2 February 2018. As a matter of fact, the economically-mature world is still a low-interest rate environment, with the exception of the US. Obviously, nominal long-term interest rates are higher in emerging markets, for example Turkey and Brazil.

In the US, the Federal Open Market Committee raised the fed funds rate three times in 2017, by a quarter of a point each time, taking it to 1.5% on 13 December. The Fed raised its key rate to 1.25% on 14 June, only two months after lifting it to 1% in March. Ten-year US government bonds carried a yield of 2.78% as at 2 February 2018 (source: TradingEconomics), which was still reasonable in absolute terms from a historical viewpoint, yet 45 basis points higher than at the end of 2017.

In Europe, both short- and long-term interest rates were (and are still) very low. On 14 December 2017, the Governing Council of the European Central Bank (ECB) decided to keep the main refinancing rate unchanged at 0% (source: ECB).

Even though short-term interest rates are set and changed by central banks, rather than by the 'markets', interestingly, market-dictated 10-year nominal rates stayed modest. To some extent, capital markets were distorted by these very low rates, with substantial liquidity channelled into different asset classes including real estate.

THAT IS WHY WE BELIEVE THAT CAPITALISATION RATES HAVE BEEN DRIVEN BY LIQUIDITY (DUE TO QUANTITATIVE EASING) RATHER THAN PROPERTY FUNDAMENTALS IN THE PAST.

Table 1: Long-term nominal interest rates (as at 2 February 2018)

10-year government bond yields (%, 2 February 2018)			
Major countries	Actual	5 October 2018	change (bp)
Japan	0.09	0.05	4
Switzerland	0.12	-0.01	13
Germany	0.74	0.44	30
Spain	1.43	1.75	-32
United Kingdom	1.53	1.27	26
Italy	1.95	2.17	-22
Portugal	1.97	2.41	-44
Hong Kong	2.08	1.72	36
Singapore	2.27	2.13	14
Canada	2.37	2.12	25
United States	2.78	2.33	45
Australia	2.83	2.78	5
Greece	3.71	5.6	-189
China	3.93	3.65	28
Peru	4.37	4.87	-50
Indonesia	6.22	6.51	-29
Colombia	6.38	6.49	-11
Russia	7.22	7.59	-37
Brazil	9.68	9.77	-9
Turkey	11.35	10.74	61

Source: TradingEconomics, 2 February 2018

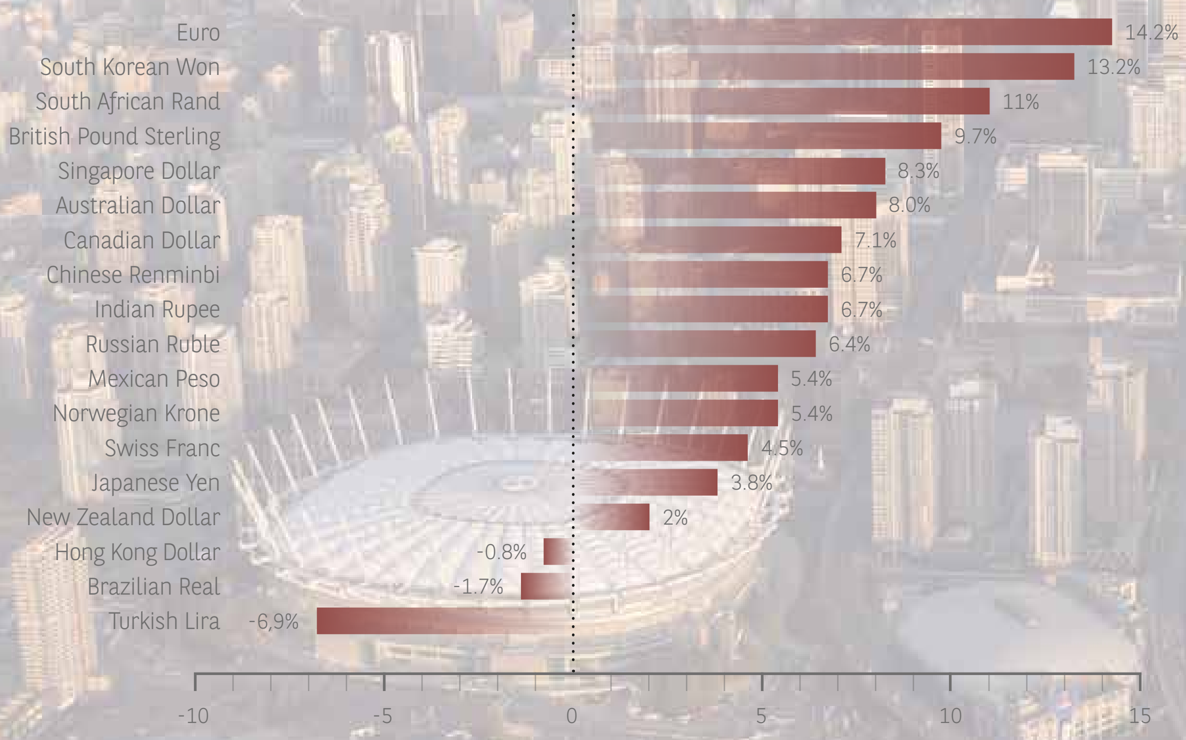
Actual yields ranked from low to high

More importantly, real long-term rates — adjusted for inflation — hovered at between 0% and -1% in 2017, or were outright negative. The UK is a good example. Annual headline inflation reached 3% in December 2017, turning 10-year real interest rates deeply negative (-1.5%, source: TrwadingEconomics). **Actually, real rates matter more to property investors. Nominal interest rates can be 'digested' by real-estate investors because, in most countries, net rents are either (partially) indexed to core inflation or subject to upward rental revisions to compensate for inflationary erosion.**

CURRENCIES AFFECTING PROPERTY RETURNS

Currencies are trickier to predict than interest rates. Against all expectations, the US dollar fell by roughly 14% against the euro in 2017. Evidently, this depreciation took a chunk of the total returns of euro-denominated investors owning property in North America. Graph 1 illustrates that the greenback was down not only against the euro but against most other currencies as well last year, albeit to a smaller extent.

Graph 1: The US dollar vs. other currencies in 2017 (as at 11 January 2018)



Source: Thomson Reuters Datastream, 8 January 2018

The eurozone economies performed so well in 2017 that some analysts coined the term 'euroboom'.

For the full year of 2017, GDP grew by 2.5%, its best performance in a decade (source: TradingEconomics, 14 February 2018). The euro has appreciated this year, trading at above 1.20 against the dollar since mid-January.

REAL-ESTATE PRICING ACROSS COMMERCIAL PROPERTY MARKETS

The decline in capitalisation rates in all geographies is practically over. Capitalisation ('cap') rates for prime office markets worldwide, and net initial yields (NIYs) have been converging towards a meagre 3-4% on average. As already mentioned, pricing was reinforced last year if we compare property yields with Investment Grade long-term bonds.

We could argue that many commercial real-estate markets are slowly converging towards a supply and demand balance, reflected by lower vacancy levels and (mildly) rising rents.

There are a few exceptions to the rule of flat property yields, such as the various logistics markets (reaping the rewards of e-commerce) and a number of specific countries that have either recovered or excelled (for instance Spain and Germany in Europe).

European logistics markets continued to perform very nicely in 2017, supported by the favourable macro-economic environment. For example, the sale of major portfolios in Germany (Hansteen and Logicor) contributed to record investment volumes in the domestic market during the first half of 2017. As a matter of fact, Hansteen Holdings, a UK property investment company, completed the sale of its German and Dutch portfolios to funds advised by affiliates of private equity firm Blackstone and M7 Real Estate for EUR 1.28 billion in June 2017. Prime yields carried by European logistics assets still declined to below 5% in some regions of Germany and the UK (source: BNP Paribas Real Estate, European Logistics Markets, September 2017).

In the US, commercial real estate continued to deliver strong unlevered total returns in spite of higher nominal interest rates. The total return for 2017 — carried by a mix of offices, retail, industrial, hotels and apartments — was just below 7%, somewhat above our expectations. The average loan-to-value ratio was 41%, and the average interest rate paid was a fraction below 4% (source: The National Council of Real Estate Investment Fiduciaries NCREIF, 25 January 2018).

WHAT ABOUT BREXIT?

The key question is whether total (unlevered) returns were impacted in 2017. According to CB Richard Ellis of CBRE, commercial property performed reasonably well, with new construction activity still limited.

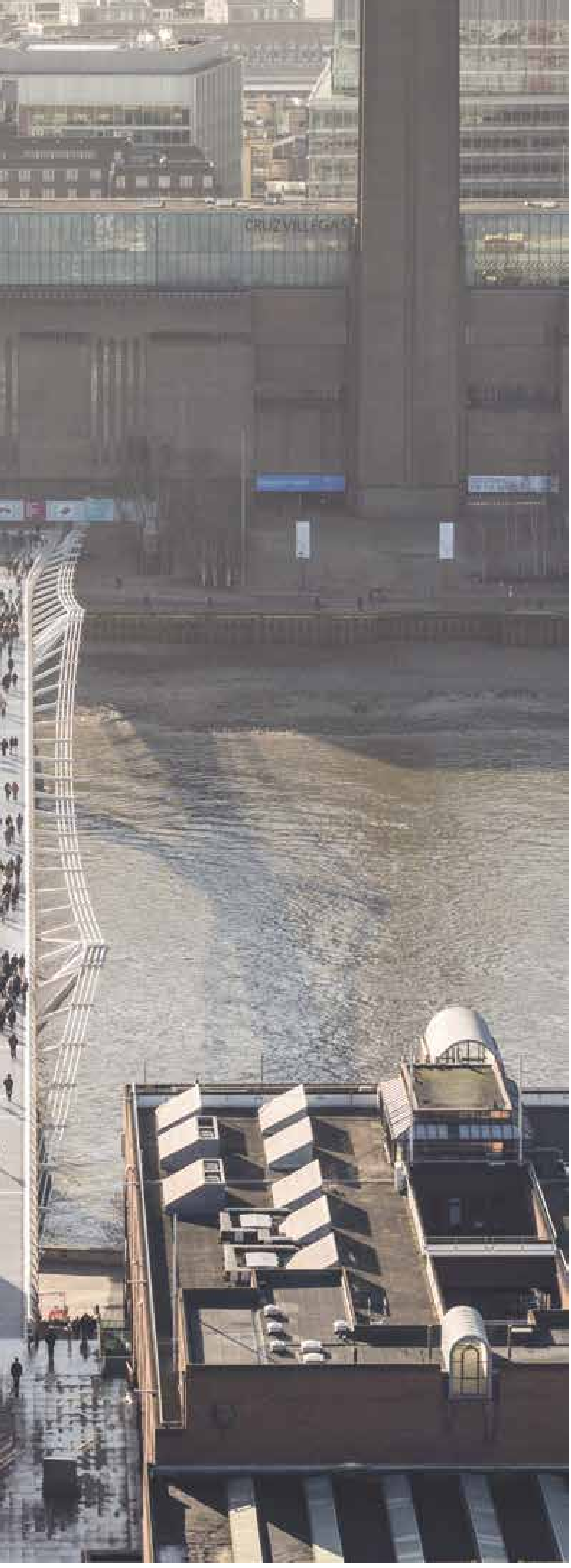
Last year ended on a strong note, taking annual total returns - before leverage - to 11.8% on average (in GBP), their best performance since 2014 and second best in 18 years.

The Industrial sector outperformed all other main sectors, recording superb total returns of 21% in 2017. Moreover, 2017 returns in the Office and Retail sectors came in at 9.8% and 8.6% respectively. Retail returns were more modest but still above the long-term average (source: CBRE United Kingdom Monthly Index, December 2017).

To Brexit, or not to Brexit, that is the question. **Investors from Hong Kong are not deterred. The London commercial property market mainly benefited from Hong Kong-based investors** who closed two of the largest-ever property deals in the UK: in March 2017, CC Land Holdings bought the Leadenhall Building, a skyscraper in the City of London, known as the 'Cheesegrater', to the tune of GBP 1.15 billion.

In July, LKK Health Products Group paid GBP 1.28 billion for another London tower, located at 20 Fenchurch Street, dubbed the 'Walkie-Talkie'. Other examples include the Cheung Kei Group, which paid GBP 410 million for 20 Canada Square in Canary Wharf, and Tenacity Group, which acquired 70 Gresham Street for GBP 271 million.

Logically, 2017 was characterised by a degree of nervousness in UK commercial markets. One in three (33%) commercial real-estate investors hinted that Germany had become their preferred region for investment purposes (source: BrickVest commercial property investment barometer, November 2017): "This is the first time that Germany has been chosen as the number one region to invest in and ahead of the UK, which was selected by a quarter of people polled (27%)".



CO-WORKING AND FLEXIBILITY ON THE RISE?

Co-working is a new phenomenon that consists of a shared workplace, often an office. But unlike in a typical office, people who co-work are usually not employed by the same organisation. **This way of working is on the increase almost everywhere in the world.** In the UK for instance, Blackstone, Carlyle and British Land (a listed UK Real Estate Investment Trust, or REIT) have all jumped on the bandwagon of London's co-working adventure (source: IPE, 16 June 2017).

The Carlyle Group invested in London's co-working market by acquiring and operating three properties. Last year, the private equity firm bought a co-working platform managed by the Adir Group, including the operational business and an 18,000 sq.ft. operational co-working office in Islington. Blackstone acquired the Office Group in a deal that valued the flexible workspace specialist at GBP 500 million. The Office Group is one of a number of firms pioneering London's flexible office and co-working market. Meanwhile, British Land launched Storey, an operator of flexible office space aimed at small companies (source: IPE).

REAL-ESTATE PRICING ACROSS HOUSING MARKETS

Europe's core housing markets have strengthened over the past five years thanks to ever-declining nominal and real interest rates, leading investors to buy tangible properties. At the same time, several housing markets that were badly hurt by the credit/property crises in 2007/2010, (in Spain, Ireland, and to a smaller degree, the Netherlands), have greatly recovered in recent years.

An example of a major core housing market is France's main residential sub-markets, which proved more resilient in 2017 than in the previous year. Indeed, transaction levels were up by 10% last year, with Paris house prices climbing by 5.8% (source: MeilleursAgents.com). Yet, the top performer was Bordeaux, recording an annual 16.5% upsurge in prices!

Iceland is a classic example of how a country's housing market was paralysed by the credit crisis for several years before bouncing back. Price growth in the Icelandic capital was massive in the 12 months to September 2017. Reykjavik prices soared by 20.4% in nominal terms (source: Knight Frank Global House Price Index, December 2017). Small is beautiful.

Nonetheless, some uncertainty pervaded Europe's housing markets at the end of last year, with mortgage financing projected to tighten in response to slightly higher nominal interest rates.

Given the demanding valuation multiples dominating a number of housing markets (France, Germany, Switzerland, etc.), we believe that would-be investors of buy-to-let properties started to adopt a more cautious stance in the second half of 2017.

Rental income returns were rather low (below 4%), after operating charges.

The UK (in particular London) is a special case.

The luxury housing markets have faced tough times over the past three years, with values falling as a result. In mid-2017, annual price declines of 7% were recorded (depending on the acquisition price range and area). However, average prices slipped by a mere 0.7% last December on an annual basis, suggesting that the top end of the market might bottom out overall. As discussed in our previous report (published in October 2017), the market needs to adapt to higher transaction costs. **So Brexit is not the only evil responsible for the lacklustre luxury housing markets** (source: Knight Frank, Prime Central London Sales Index, December 2017). Furthermore, the impact of the (Crossrail), 'Elizabeth Line' named after Queen Elizabeth II, in the capital's core housing areas is a matter of concern.

In the US, data for house prices were steady in 2017, with still good results. In any case, most markets still gained in value (6.4% on average, 12.7% for Seattle), and performed better than anticipated (source: S&P Dow Indices, 30 January 2018).

Turning to Asia, **housing markets are fragmented, and expensive in absolute terms.** As projected, the housing market in Shanghai continued to contract in 4Q17 due to limited supply and squeezed lending conditions (source: Jones Lang LaSalle Asia). Indeed, the affordable housing market and the luxury segment plummeted by 47% and 80% respectively on an annual basis. Buyers have become much more rational in recent months (a stark contrast to the frenzied buying spree in previous years). We could say that house prices remained divergent in China, for both new and existing homes. Last December, home prices in several tier-1 cities such as Beijing, Shenzhen, Shanghai and Guangzhou, fell slightly while residential prices in second- and third-tiered cities rose by approximately 0.5% month-on-month (m-o-m, source: National Bureau of Statistics of China, January 2018). **As housing regulations in large cities tighten, would-be buyers are starting to eye opportunities in 'medium-sized' cities.**

Australia's housing markets have long been isolated from Asian countries performance-wise.
Nevertheless, they may see a correction in the coming months (source: Jones Lang LaSalle Asia). Singapore's residential markets started bottoming out in 2017, though not significantly. The Taipei real-estate market remained in the doldrums last year. "Price cuts remain the key to boosting transactions for residential and commercial properties" (source: Cushman & Wakefield). What a contrast with New Zealand! **Indeed house prices have posted some of the strongest increases in Asia-Pacific since the start of the decade, but efforts by the authorities to curb the stretched market appear to be gaining a grip.** At the end of last year, New Zealand's rate of house price growth was about half what it was at the end of 2016, although some regions are still hitting record prices. The latest figures from the Real Estate Institute of New Zealand (REINZ, 18 January 2018) show that the national median sale price rose by 5.8% in 2017. Compare this with the annual rate of growth of 11% a year earlier. Policies implemented by the new government could moderate gains further. These include a more onerous tax regime for investors of residential property. Volumes plummeted by more than 10% in 2017.

In the meantime, it was business as usual in Hong Kong. The pearl of the orient commanded the highest house prices in the world! Even though many market observers do not understand how and why prices can stay so high for so long, it is pretty obvious that Hong Kong is a classic case of low supply and strong demand (in particular among investors from Mainland China). Also, a large slice of tax income revenues collected by the Hong Kong authorities derives from land sales (to developers).

REAL-ESTATE PRICING, CHANGE IN LENDING RULES AND THE TAX IMPLICATIONS

The UK government **announced a new tax law in its Budget Statement published in November 2017,** which enlarged the scope of UK capital gains tax, levied on non-residents, to all UK property, which means not only residential property but commercial property too. This could have consequences for family offices. Consultations on this matter were closed on 18 February 2018, and draft legislation should be published this summer. Measures will be included in the Finance Bill 2019, and will take effect in April 2019.

On 1 January 2018, the French wealth tax ('Impôt sur la Fortune' - ISF) - based on all assets owned by the household, as defined for tax purposes) when net wealth exceeds a certain threshold (EUR 1.3 million) — was replaced by a new wealth tax ('Impôt sur la Fortune Immobilière' - IFI), that will be assessed solely on the real estate owned by the taxpayer if the value of the household's real-estate net assets exceeds EUR 1.3 million.

Denmark's new lending regulations that came into force on 1 January 2018 may have a dampening effect on house prices in 2018. The law stipulates that if a loan exceeds 60% of the value of the home and the total debt of the household is more than four times its annual income, there will be some lending restrictions. In neighbouring Sweden and Norway, house prices started to decline in 2017 when the authorities introduced stricter lending regulations.

In Flanders (Belgium), stamp duty is to be lowered to 7% in mid-2018 (from 10% previously), which could have a positive effect on the local housing market. Nonetheless, Fitch, a credit rating agency, warns against overheated house prices in Belgium in general. Last year, higher house prices pushed up the household debt/income ratio to a whopping 104%, above the euro area average, while overall lending growth to households picked up from 2.0% y-o-y at end-2014 and to around 5.0% over the same period. At the same time, Belgian households' net wealth remained very strong, with net financial wealth at around EUR1 trillion (around 246% of GDP) in 2Q17, the highest in the eurozone (source: Fitch, 1 December 2017).

In the US, homeowners nationwide rushed last December to prepay their property tax for 2018 before the new tax law took effect on 1 January 2018. The law effectively raised the levy on high-end homes. The new legislation caps the amount of state and local taxes that taxpayers can deduct from their federal tax bill at USD 10,000.

INVESTORS STILL CHARMED BY THE LISTED SECTOR

The combination of declining long-term bond yields and the decrease in property capitalisation rates has made Real Estate Interest Trusts (REITs) very popular in recent years. In spite of occasional volatility (certainly in relation to higher expected interest rates) last year, REIT performance jumped from -5% in Japan to over 38% in Hong Kong, with many REIT markets recording double-digit total returns. North America was a plausible exception, given the less accommodative monetary policy implemented by the Fed.

Double-digit returns (in local currency) in markets such as Europe beat our own forecasts. We would have been more than happy with a total return made up of only gross dividends. Actually, this was the case in the US. The good total return for UK REITs is surprising given the bleak outlook for London's office markets in 2018. On the other hand, loan-to-values carried by UK REITs are now very reasonable, hovering at around 30% in December 2017 (compared with 38.5% for Continental Europe, source: European Public Real Estate Association EPRA).
In Singapore, fundamentals are stronger - in particular within the residential sector where supply has dwindled and affordability has improved in the past two years. **Hong Kong REITs delivered a +38% levered return, and today offer a nice alternative to Mainland China.**

Table 2: Annual performance of REITs in 2017 (in local currency)

Index (as at 3 January 2018)	Currency	1M	1Y	3Y*	5Y*
FTSE EPRA/NAREIT Hong Kong	HKD	3.34	38.10	8.73	5.54
FTSE EPRA/NAREIT Singapore	SGD	3.68	33.11	9.48	5.79
FTSE EPRA/NAREIT Germany	EUR	4.23	30.42	19.43	19.35
FTSE EPRA/NAREIT Europe ex UK	EUR	3.87	17.31	13.12	13.27
FTSE EPRA/NAREIT Asia	USD	2.46	16.55	4.70	3.55
FTSE EPRA/NAREIT France	EUR	6.74	16.19	10.90	10.36
FTSE EPRA/NAREIT Europe	EUR	4.79	14.47	8.83	12.18
FTSE EPRA/NAREIT UK	GBP	8.35	13.59	4.71	11.08
FTSE EPRA/NAREIT Belgium	EUR	2.84	9.48	10.74	12.24
FTSE EPRA/NAREIT North America	USD	-0.51	3.78	4.17	8.03
FTSE EPRA/NAREIT Japan	JPY	0.03	-4.95	-3.24	7.19

Source: Datastream, 3 January 2018 *Annualised return

Continental Europe in general, Germany and the UK (the list is not exhaustive) produced attractive total levered returns in excess of 10% in local currency during the five years to 3 January 2018. What's more, North America generated a total return of 8% over the same period.

That said, we are concerned about the lack of potential of UK reits in general.

In fact, UK REITs have been selling and foreign investors have been buying in recent months. In July 2017, British Land announced that it was distributing GBP 300m to shareholders via a share buy-back programme during its financial year. In other words, GBP 156m of the full GBP 300m had been committed as at 30 September 2017 (source: British Land). The UK's second-largest REIT is of the opinion that there are fewer attractive opportunities in the office market today, so its own (discounted) shares offer better value than future asset acquisitions. In February, Great Portland Estates sold Rathbone Square to German fund Deka for GBP 435m, and paid out a special dividend of GBP 110m to shareholders on 31 May 2017 (source: Great Portland Estates). This is in sharp contrast to private investors reporting high-profile transactions (such as the 'Walkie-Talkie').

As a reminder, REITs are tax pass-through structures. Therefore, they are exempt from corporate taxes as long as they comply with a number of conditions such as paying out the bulk of net profit in dividends.

Hence, REITs are commonly referred to as 'dividend plays' (individual investors are subject to a tax on dividends). And dividends booked by REITs are attractive compared with cash income carried by Investment Grade bonds for instance. They are a contributing factor to REIT valuation metrics.

WHAT CAN WE EXPECT GOING FORWARD?

UNLEVERED TOTAL PROPERTY RETURNS

It is reasonable to assume that the period of high total real-estate returns — before leverage — is behind us, but without any serious re-pricing on the cards. This is certainly true for the world's prime commercial property markets. On the other hand, investors should not fear another wave of volatility seen in other more 'financial' markets (such as bonds and equities, witnessed on 6 February 2018). Occupational property markets do not behave in the same way.

In any case, tighter monetary policy is looming on the horizon. In the US, our wealth management economists are expecting four new hikes of 25bps each in 2018 (and none in 2019), which would take the rate to 2.50 before year-end.

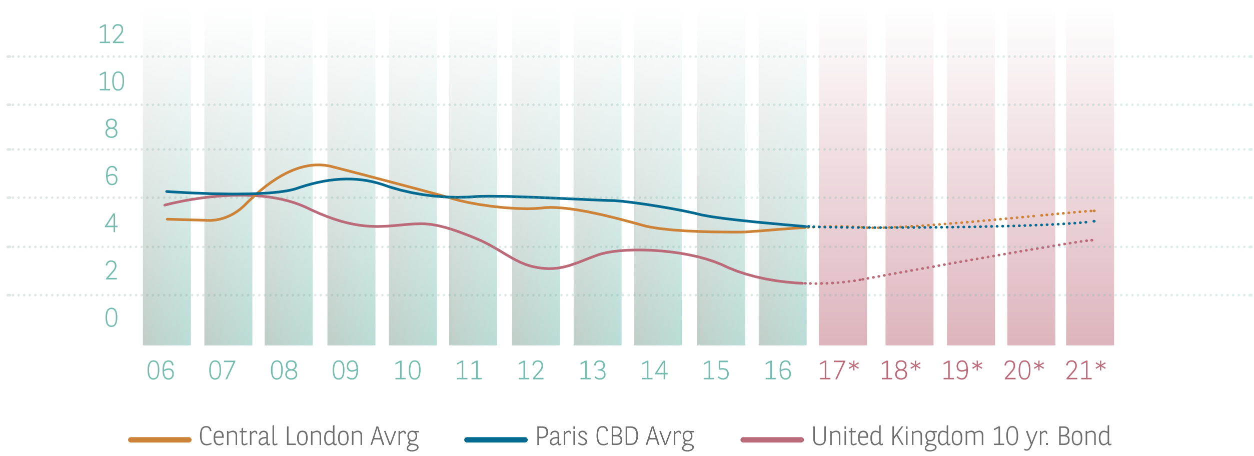
BNP Paribas Wealth Management forecasts the 10-year sovereign bond yield to reach 3.25% in 12 months.

The US inflation-adjusted bond yields, which had fallen mildly in previous months, have started edging up as well. Indeed, the real yield on 10-year Treasury Inflation Protected Securities ('TIPS') was 0.548% at the 18 January 2018 auction, the highest for any 9- to 10-year TIPS auction since January 2016 (source: TIPSWatch).

With respect to Continental **Europe, the ECB is not expected to hike its benchmark interest rates in 2018.** However, the central bank's extended bond-buying programme will be tapered to a halt by the end of next year as long as the inflation outlook picks up.

The real-estate total return can be broken down into two components, namely income return (from net rents) and appreciation return (realised and non-realised capital gains/losses). These components are relevant for three major investment objectives: income, growth and a combination of income and growth. However, there may be an issue with the capital performance return for a number of markets, as we believe a further compression of property yields is very unlikely, given the narrowing spread with long-term nominal interest rates. The thin spreads between property yields and sovereign bond yields are shown in Graph 2.

Graph 2: Spreads between office property yields and risk-free interest rates (yields in %)



Source: BNP Paribas Real Estate, February 2018

Table 3: Capital appreciation returns in Europe's office markets (1 February 2018)

	2017	2018	2019	2020	2021	2022
Berlin	22.9	16.5	7.7	-0.2	-0.5	-3.6
Madrid	15.5	11.0	8.3	1.7	-2.1	-5.8
Frankfurt	18.6	9.1	7.1	3.3	-3.1	-1.9
Munich	14.7	8.2	3.8	3.2	-2.6	-4.5
Lyon	7.3	7.6	-1.9	-0.7	-0.5	-0.6
Barcelona	10.5	5.9	1.9	-0.4	-1.3	1.1
Copenhagen	5.8	5.4	5.5	-2.3	-3.6	1.2
Hamburg	14.4	5.4	3.7	1.6	-1.4	-3.3
Amsterdam	12.0	5.1	0.5	-3.0	-1.9	-3.4
La Défense	11.3	4.7	-0.0	-1.7	-4.1	-3.0
Paris CBD	8.5	4.6	0.6	-1.3	-2.5	-1.1
Cologne	12.6	4.3	1.0	1.6	-1.2	-2.0
Lisbon	7.5	3.3	1.7	-0.3	0.8	-5.6
Greater Paris	6.0	3.0	0.4	-1.1	-0.9	-0.9
Düsseldorf	11.2	2.9	0.6	1.3	-0.5	-1.2
Central Paris	5.8	2.5	-0.1	-0.8	-1.9	-1.8
Brussels	5.0	2.5	0.2	-0.5	0.4	-3.6
Stockholm	13.7	1.6	-1.9	3.0	3.6	2.7
Warsaw	-2.3	1.6	-3.1	-0.9	0.1	-0.8
Dublin	6.0	1.2	-1.3	-3.1	-3.4	1.2
Prague	5.3	1.0	-4.0	-3.5	-2.9	-6.0
Helsinki	0.1	0.8	3.3	3.6	-0.9	1.2
Rome	-0.1	0.6	-3.6	-1.5	0.1	0.1
Budapest	11.0	-0.1	-1.9	-4.5	-2.6	-1.9
City	4.2	-1.8	-5.6	-3.4	0.4	2.9
West End	4.0	-2.6	-6.0	-3.9	0.2	2.5
Central London	2.9	-3.0	-5.5	-3.4	0.5	2.5
Milan	1.2	-4.1	-0.2	-1.8	2.3	1.7
Birmingham	4.8	-5.8	-4.2	-0.8	5.7	2.9

Source: BNP Paribas Real Estate, February 2018. Expected capital appreciation returns for 2018 were ranked from high to low

Table 3 shows BNP Paribas Real Estate's forecast office total returns for a number of European cities over a five-year period.

In the European office market, **it is striking to observe that any decrease in value will occur in UK cities this year (London, Birmingham, losses expressed in pounds), with the exception of Budapest and Milan.** However, many other European capitals could also become affected from 2019 onwards.

If we factor in the more stable income return, total returns may fluctuate between 0.9% for Birmingham and 20.2% for Berlin in 2018 (source: BNP Paribas Real Estate, February 2018. Nonetheless, they should weaken considerably in 2019 and 2020 given the poor capital performance anticipated for European offices.

In the US, **we believe that total returns booked by offices could end up somewhat lower than in Europe this year,** though returns may be flat in subsequent years (in US dollar). Office returns in a number of emerging Asian countries may produce slightly better results this year.

WHAT ABOUT THE IRR?

We believe that the Internal Rate of Return (IRR) could be somewhat higher than the total property return, thanks to a reasonable leverage. That said, the (positive) leverage effect could be hampered by higher interest rates. The loan-to-value ratio should reflect the markets' good common sense, and oscillate at around (or below) 50% for a non-aggressive investment strategy. Leverage boosts IRRs while it magnifies the risk of equity in the event of falling market values.

As a reminder, IRR attribution is usually broken down into three components:

• **the initial-cash-flow yield,** which is now historically low for prime property;
• **the subsequent-cash-flow change,** which is a very important factor for the IRR at the moment. Indeed, the initial yield may be incremented by the change in cash flows over time, for instance thanks to (partial) indexation of rents to inflation, upward rental revisions, higher rental streams attributable to refurbishment schemes, a better tenant mix, etc.;
• **the yield-change component or 'valuation' change between the beginning and end of a property's holding period.** As mentioned above, it will be very tough to obtain a (sizeable) positive valuation gap for prime property in the near future, also because the real depreciation rate of a building is normally 1-2% per year. On average, we could argue that the evolution in values is synchronised with expected inflation, yet inflation is still marginal in many mature economically-advanced countries. Nonetheless, the yield-change component can contribute to the IRR if the investment strategies of dedicated asset managers are oriented towards 'value' creation to enhance the IRR (value-added/opportunistic approaches). The final IRR depends on the type of property, the country of investment, and often the investor's cultural background.

REAL-ESTATE DIVERSIFICATION, WITH A FOCUS ON INCOME DIVERSIFICATION

In our previous report published in October 2017, we questioned whether an international property investment was still a smart idea. The answer was (and still is) affirmative because property markets tend to be less correlated — thus more diversified — in 'normal' times (when there is no major financial crisis). To cite but a few examples, the UK's commercial property markets are not the same as Germany's in terms of prospects today. In Asia, Singapore and Taiwan's housing markets cannot be compared with the Hong Kong residential market. In most countries, the retail and logistics markets are not moving at the same pace. Different return patterns may be observed in the listed real-estate sector as well.

As a consequence, we believe it worthwhile to diversify across property markets and products in different regions of the world. The reason is not only because of the outperformance that investors expect outside their domestic markets, even after assessing the obstacles to an international property investment, such as the cost of investing abroad, transaction costs, information costs, political risks and lack of liquidity, but also because of diversification of rental income. Regarding currency movements, investors tend to follow risk and return in their own currency. So, in the past few years, investors buying in foreign lands have been looking for a higher total return through growth. As a matter of fact, the projected capital performance generated from their international investments has been key at all times.

Table 4: Expected real-estate total returns

Return expectations in the coming years (irrespective of geography)		
	Annual income return (after operational charges)	**Annual realised or unrealised capital growth**
Prime/core (+)	**2-5%**	**2-3%**
	• Depending on property type • Very low for residential investments • Higher for logistics assets (followed by offices and retail) • Less favourable interest-rate environment • LTVs should be realistic, debt financing at fixed rates	• Slowing/stabilising capital appreciation • Capital gains more in line with inflation projections • Cap rates less driven by capital markets (liquidity) • Less favourable interest-rate environment • Potential of real estate compared with prospects of other asset classes
Value-Add/ opportunistic	**0-5%**	**5-10%**
	• Not always required by investors • Generally lower compared to stabilised properties	• Value to be created by experienced asset managers • Acquisition below replacement cost • Off-market deals at a discount • Conversions, extensions, upgrading, enhanced asset management

Source: BNP Paribas Wealth Management, February 2018

However, we believe that the main rationale for going international should be income and not necessarily capital appreciation (pricing). Despite the fact that many prime property markets carry similar capitalisation rates, it is wise to expand internationally in order to secure net rental streams across different markets in the long run (different tenants, markets and legal frameworks, etc.). In addition, net rental income is still higher than what other asset classes of similar risk offer at present (e.g. Investment Grade bonds in mature markets). So real-estate income still provides a clear advantage over other income-producing asset classes. **This is why real estate is attractive from a relative perspective, thus in relation to other investments, and why debt strategies and logistics were so popular in 2017 (mortgages, mezzanine financing, etc.).**

Unmistakably, investors with a growth investment objective do not accept a modest total return on property investments, whether domestically or internationally, even though property income returns exceed other investment income. Those investors should continue to diversify through property funds (or via direct investments if affordable), with asset managers seeking value across markets and segments. **Obviously, the growth objective implies a relatively long investment horizon (often up to 10 years), with no immediate need to use the invested cash. Moreover, IRRs will be primarily driven by the valuation-change return component.**

At a fundamental level, investors with an income objective accept smaller total returns while investors with a growth investment strategy 'require' higher IRRs to compensate for the additional risk taken, as shown in Table 4.

Total unlevered return	IRR
	Below 10% on average
4-8%	Modest positive leverage still possible Unless in the event of a spike in interest rates
	Above 10% on average
5-15%	Modest positive leverage still possible Unless in the event of a spike in interest rates

Institutional and private investors alike should prioritise diversification, acquiring direct property in markets they know well, and exploit (other) private and listed property vehicles to gain exposure to property markets they are perhaps less familiar with. Indeed, **we deliberately embrace real-estate securities such as REITs (funds invested in REITs), as they give access to more remote real-estate markets.** Clearly, listed property companies are invested in real properties, but they also operate in a parallel market to the physical property market, in other words, the stock exchange. So stocks can present different risk (volatility) and return characteristics, mainly in times of soaring inflation. **Therefore, investor focus should primarily concentrate on dividend yields in the coming months.**

As mentioned above, we believe that investors will 'demand' a larger real total return (before leverage) in the near future to compensate for real-estate risk. Steady or higher cap rates temper total returns, as capital appreciation rates deteriorate. We assume that total returns (before leverage) will not exceed 10%.

We stick to our Neutral stance on prime commercial property — in all geographies — because of modest total return projections. But acquiring prime/core assets is still pertinent as long as investors are not highly-indebted and do not buy 'long-term' assets with short-term debt. LTVs are suitable hovering at around 50%. If inflation returns on a sustained basis, rental contracts will be indexed in many countries (representing gradual protection against inflation).

Clearly, investors should enter specific real-estate markets showing a positive momentum. Flexible workspace and co-working are now an important real-estate trend. There is a growing appetite for flexible 'state-of-the-art' offices.

Moreover, urban logistics centres remain very appealing, because investors like relatively high property yields (irrespective of geography).

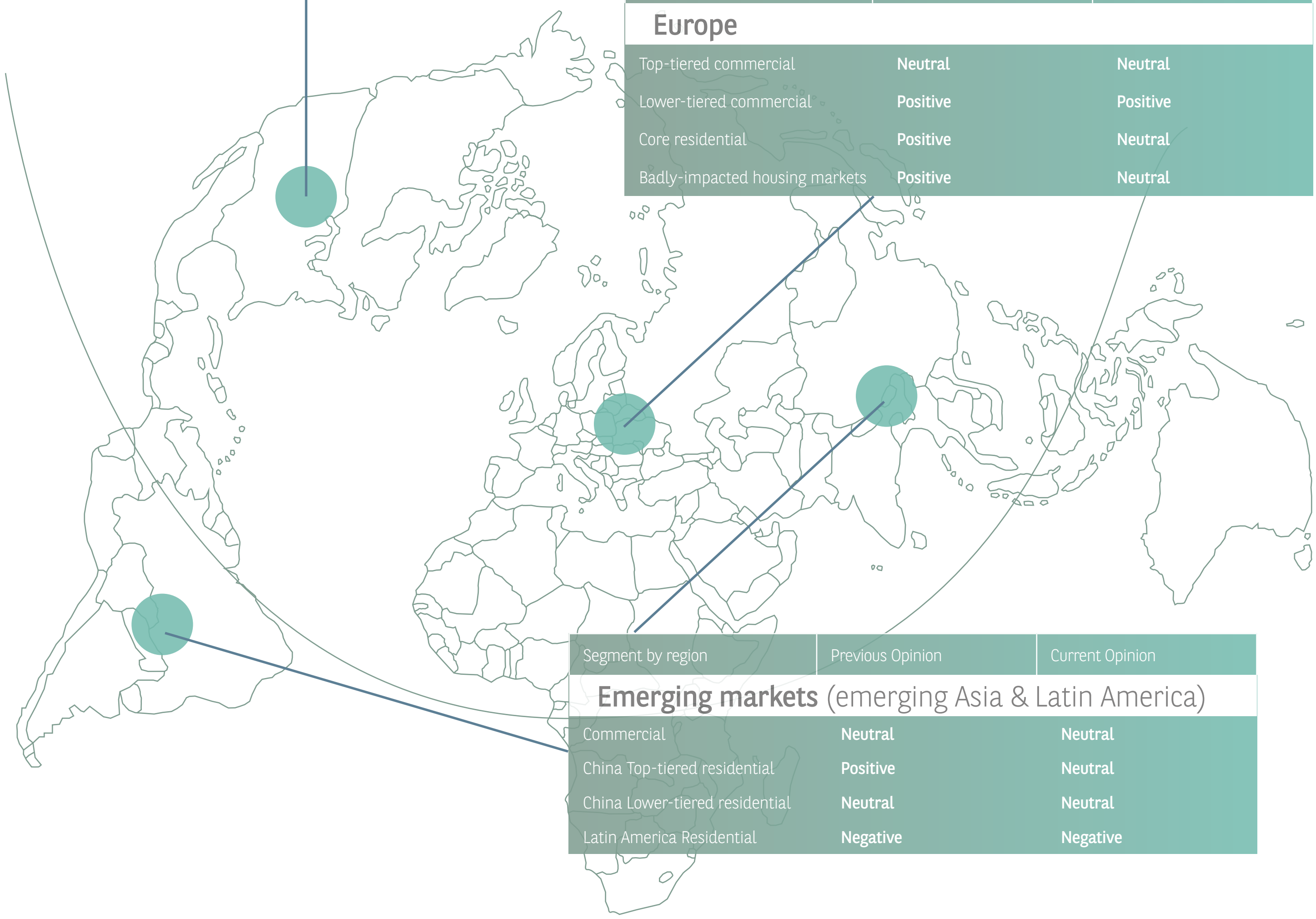
We maintain our Positive stance on value-added/ opportunistic strategies, irrespective of the location, with 'global' managers investing 'locally'. Examples are numerous: a key principle is the purchase of properties (commercial and residential) at a discount to the replacement cost and the identification of niche markets or sub-markets.

With respect to European housing markets, **we have changed our recommendation from Buy to Neutral for both the established and less mature residential segments.** We justify this by a challenging price pattern in many mature markets, new tax implications for valuations and the fact that previously-beleaguered markets (e.g. Spain and Ireland) have recovered speedily since the last credit crisis.

Overall, we believe that REITs are fully priced, but not overpriced. **We have adopted a Neutral recommendation on Continental European REITs for investors with 'long-only' strategies.** The current accommodative monetary policy remains a key driver. We stay Negative on UK REITs (in spite of soaring share prices in recent months), as equities may start to fall in anticipation of future losses in capital values. We keep our Neutral recommendation on US and Asian REITs.

OUR REAL-ESTATE STRATEGY BY LOCATION

Segment by region	Previous Opinion	Current Opinion
North America		
Top-tiered commercial	**Neutral**	**Neutral**
Lower-tiered commercial	**Neutral**	**Neutral**
Residential	**Neutral**	**Neutral**



Segment by region	Previous Opinion	Current Opinion
Europe		
Top-tiered commercial	**Neutral**	**Neutral**
Lower-tiered commercial	**Positive**	**Positive**
Core residential	**Positive**	**Neutral**
Badly-impacted housing markets	**Positive**	**Neutral**

Segment by region	Previous Opinion	Current Opinion
Emerging markets (emerging Asia & Latin America)		
Commercial	**Neutral**	**Neutral**
China Top-tiered residential	**Positive**	**Neutral**
China Lower-tiered residential	**Neutral**	**Neutral**
Latin America Residential	**Negative**	**Negative**

Property stocks	**Neutral on Continental Europe, the US and Asia. Negative on the UK**	**Neutral on Continental Europe, the US and Asia. Negative on the UK**

EUROPE

COMMERCIAL REAL ESTATE (CRE)

Top-tiered (prime) real-estate markets

We stick to our Neutral stance on prime assets in Continental Europe despite high valuation multiples. We are of the opinion that both institutional and private investors may continue to target these key markets. Obviously, capital gains are most likely to be limited. Moreover, modest capital losses should not be ruled out in the short term. We advise investors to focus on steady income streams for the time being, with cash income looking more protected in prime/core locations. With the rental cycle advancing in Europe, investors should look out for spots where rental income is predicted to grow (Germany, France, Spain). **In a word, rents and growth in rents are more significant than yield compression.** In the UK, office and retail space might suffer from another fall in capital values in 2018. Conversely, the pound is projected to stabilise against the euro (with the EUR/GBP settling at around 0.90 in the coming months, source: BNP Paribas Wealth Management). **But lower values would open up new investment opportunities in the medium term.**

Clearly, Europe's commercial property markets are expected to do fairly well this year. When we look at a few indicators that characterise both the supply and demand side of the real-estate space market — such as vacancy rates, rent levels and the number of new constructions started — we are generally at ease with Europe's property market analysis. According to BNP Paribas Real Estate, the largest cities (London and Paris) will remain the most expensive in terms of prime rents. **Supported by a fall in the vacancy rate and a stable economic environment, German cities will post one of the sharpest annual rental growth rates; Berlin (7%), Frankfurt (4.2%) Hamburg (2.2%) and Munich** (2.0%, source: BNP Paribas Real Estate, European office prospects, 12 December 2017).

2017 was a very successful year for the office lettings market, with take-up totalling 10.08 million m² in the main European markets (source: BNP Paribas Real Estate, Main Offices in Europe, 4Q17). The 14% increase in volumes compared with last year was, by far, the best result in ten years. The market thrived in most cities last year, especially in the three largest countries, where large occupational deals drove the market (Germany, London and Paris).

The average vacancy rate in the 14 main European markets shrank again in the last quarter to 7.1%, contracting by 80 basis points year-on-year.

Prime rents increased mostly across Europe last year, with a 5% increase on average. Rental values rose for the first time since 2015 in Central Paris with EUR 850/m²/year in Paris CBD (Central Business District) Etoile (+6%). The most noticeable changes were seen in Berlin (+16% or +EUR 396/m²/year), Brussels (+13% or +EUR 310/m²/year), and Milan (+12% or +EUR 550 m²/year).

Nevertheless, capital markets could temper the good news with a change in monetary policy on the cards. This is a bit ironic: capital markets were very supportive in previous years, usually in the absence of robust property fundamentals. Today, property indicators are improving (higher rents, brighter inflation outlook) though capital markets may behave more prudently. **Therefore, real estate (including prime real estate) should no longer be considered as long-term bonds.**

Lower-tiered (second- and third-tier) property markets

A so-called 'value-added' investment approach is a higher-return real-estate strategy, which we favour in both Continental Europe and the UK. In reality, this is the only way to generate above-average property returns (at least 10%). However, the track record of value-added asset managers should be outstanding because we foresee more challenging investment conditions in the coming months, especially after the billions of dollars and euros raised in recent months by top asset managers. As always, deteriorating investment conditions could create new (and more affordable) investment opportunities at several stages of the market cycle, as witnessed during the last credit crisis. Finally, asset managers should adopt a more 'contrarian' stance from time to time.

Transactions could create value through the restructuring or recapitalisation of property portfolios, by taking listed portfolios private, or alternatively, through the (re)development of assets with the aim of unlocking value. Owning an efficient asset management platform is paramount to obtaining or securing higher rental income as well. Under-managed property portfolios could be acquired below replacement cost, thus offering upside potential. Portfolios could be refinanced as well to lower the cost of borrowing.

An example of a landmark deal in 2017: Blackstone announced on 8 June 2017 that it had closed its fifth European opportunistic real-estate fund, Blackstone Real Estate Partners Europe V ('BREP Europe V'). Together with the commitments from Blackstone and its affiliates, BREP Europe V has amassed EUR 7.8 billion of capital commitments, making it the largest-ever real-estate fund in Europe.

Brookfield Property Partners L.P. ('Brookfield') and its joint venture partner Qatar Investment Authority ('QIA') are the owners of London's Canary Wharf Group (through their GBP 2.6 billion acquisition in May 2015 of Songbird Estates plc and their acquisition of a slice of Canary Wharf Group that Songbird did not own). Canary Wharf Group is involved in office, retail and residential development schemes, and Brookfield intends to keep around 1 million sq.ft. in three high-end residential towers under development. Brookfield wants to benefit from London's growing number of renters as it has become practically impossible to get onto the property ladder (source: Financial Times, 29 December 2017).

Graph 3: European office property yields in 4Q17

Source: BNP Paribas Real Estate, Jones lang LaSalle, January 2018

RESIDENTIAL REAL ESTATE

We downgrade Europe's core housing markets from Positive to Neutral.

The UK housing markets

According to Black Brick Solutions, 'best in class' properties are still sought-after, and may achieve prices which "reflect their rarity value and may well distort the general statistics". Nevertheless, there is bound to be a surplus of luxury new-build apartments, particularly in Mayfair. The following locations still have units for sale: 20 Grosvenor Square, One Grosvenor Square, Clarges, the penthouses at One Burlington Street, Hanover Bond on Hanover Square as well as the units in the converted Mirabelle restaurant on Curzon Street. There are also units at Belgravia Gate and residences at the Peninsula Hotel which are on Hyde Park Corner that, although not technically Mayfair, are so close that they will impact the market. The same is true for the Almacantar property development at Marble Arch and Centrepoint.

Another important forthcoming event is the opening of Crossrail in 2018 (now called the Elizabeth Line), which is expected to transport over 200 million passengers per year. It will link London's main employment, entertainment and transport hubs as well as business districts: Heathrow airport, the West End, the City and Canary Wharf (source: Crossrail).

How will the Elizabeth Line impact the capital's prime/core housing markets, given the better connectivity provided by Crossrail? Will the middle-market segment in the centre of London suffer, with first-time buyers moving towards the East End? Could the high-end markets be equally affected?

In the meantime, the average price of a London home dipped in 2017. Whereas prices were up by 2.6% at the national level, they were marginally down 0.5% in London in 4Q17 for the first time since 2009 (source: Nationwide). Furthermore, inflation stood at 3% in January 2018, so 2017 house prices failed to keep up with the pace of inflation (source: TradingEconomics).

The French housing market

The French housing market delivered a very good performance in 2017, with house price growth remaining in a wide range of 0% to 17%. The country's major cities outperformed the national average by about 2%. **Bordeaux topped the rank, recording a splendid 16.5% increase in house prices in 2017** (EUR 3,700/m² compared with EUR 3,600/m² for Lyon, source: MeilleursAgents.com). Other cities enjoyed a more modest (albeit attractive) annual increase, varying between 4% and 8%: Lyon (+7.7%), Paris (+5.8%), Nice (+5.8%), Nantes (+5.5%) and Toulouse (+4.2%). As always, there were some laggards too: Marseille (+0.1%), Strasbourg (+1.7%), Montpellier (-1.9%) and Lille (-0.2%, source: MeilleursAgents.com. **Obviously, Paris is still a safe bet, with homes with bigger surface areas, in particular, having enjoyed a strong 2017.** For example, prices for three-bedroom apartments picked up by more than 7% whereas smaller flats/studios posted a smaller annual price growth of about 4.3%.

What about Europe in general?

As already mentioned, Europe's housing markets performed very well during the 12 months to 30 September 2017, with many European countries posting decent real returns (after inflation). Annual house prices in Romania gained over 9% (not to mention Iceland posting an exceptional 19% after inflation), closely followed by Sweden and the Netherlands (roughly 6% each). Capital appreciation returns must be assessed along with annual net rental income to determine annual total returns (before any leverage). Table 5 shows real house prices in more detail.

Outside Europe, the residential markets in Hong Kong and Canada remained buoyant over the same period whereas the US only achieved a few per cent in real terms. Unsurprisingly, Dubai stayed in red territory along with Qatar (Qatari residential prices plunged during 3Q17 as a result of political tension with neighbouring countries).

Table 5: House price changes (inflation-adjusted) as at 30 September 2017

House price change (inflation-adjusted) as of 30 September 2017				
Rank	**Country**	**y-o-y (%)**		**q-o-q (%)**
		3Q16	**3Q17**	**3Q17**
1	Iceland	10.85	18.76	3.22
2	Hong Kong	-5.67	13.14	0.87
3	Macau	3.49	10.53	-5.01
4	Canada	10.18	9.69	1.46
5	Romania	9.02	9.36	3.20
6	Philippines	7.56	6.58	0.17
7	Sweden	7.41	5.87	1.67
8	Netherlands	7.09	5.69	2.17
9	Montenegro	-4.57	5.07	1.92
10	Slovakia	6.18	4.80	0.45
11	US (FHFA)	5.08	4.48	0.97
12	Germany	5.85	4.25	1.75
13	Portugal	2.95	4.04	1.78
14	US (Case-Shiller)	3.61	3.83	0.74
15	Chile	1.46	3.43	1.75
16	Latvia (Riga)	7.32	2.58	1.73
17	Japan - Tokyo	6.56	2.56	1.83
18	Spain	2.19	1.42	1.92
19	Switzerland	2.05	1.40	0.43
20	Austria (Vienna)	1.78	1.28	0.62
21	Norway	3.77	0.96	-2.63
22	Israel	5.80	0.67	0.69
23	Finland	0.84	0.36	0.14
24	New Zealand	5.85	0.04	-1.24
25	Estonia (Talinn)	6.92	0.00	2.41
26	Turkey	6.18	-0.05	0.75
27	UK (Nationwide)	4.38	-0.08	0.32
28	Lithuania (Vilnius)	5.10	-0.20	0.54
29	China (Beijing)	37.87	-0.31	-3.22
30	Puerto Rico	0.51	-0.35	6.17
31	Indonesia	-0.30	-0.47	-0.30
32	Taiwan	-2.95	-0.51	-1.60
33	Brazil - São Paulo	-7.71	-1.13	-0.20
34	Mexico	3.84	-1.42	-0.63
35	UAE - Dubai	-3.91	-2.84	-0.97
36	Qatar	-14.09	-2.85	-8.98
37	Mongolia	-7.92	-5.70	-0.99
38	Russia	-11.34	-6.69	-1.07
39	Ukraine - Kiev	-2.93	-6.81	-2.51
40	Egypt	-1.24	-8.68	7.65

Source: Global Property Guide as at 3Q17. Annual housing price change ranked from high to low

Spain and property taxes

Investors buying Spanish property often do not realise that they are subject to an array of property taxes. Indeed, tax implications are often taken too lightly in Spain, a popular hub for foreign property buyers.

First, local property taxes are commensurate with the size of the town or city. As a matter of fact, would-be investors should check that all previous local property taxes have been paid by the seller before purchasing a property, because otherwise the new owner would be liable. A non-resident owning a Spanish property must file an annual income tax return. Either the rental income is taxed or, if none, a slice of the so-called 'cadastral value' of the property is taken for tax purposes. In addition, the seller is subject to a capital gains tax upon divestment of the property. On the other side of the fence, if a buyer acquires a property from a non-resident, he/she is required to retain 3% of the purchase price, and pay it to the Spanish tax authority. Ironically though, the asset acts as a guarantee for the seller's capital gains tax payment, so the property could even be seized if the tax due is not paid! Evidently, when a new home is purchased from a developer (or bank), VAT and stamp duty are due, the latter being the highest levy. Obviously, the resale of existing houses is also subject to a transfer tax.

We downgrade Europe's improving housing markets (Spain, Portugal, Ireland and the Netherlands) from Positive to Neutral because we are less optimistic about their growth prospects.

NORTH AMERICA

COMMERCIAL REAL ESTATE

Top-tiered real-estate markets (prime real estate)

We maintain our Neutral view on prime real estate for the US markets. While quarterly total returns (unlevered) remained modest, returns in the fourth quarter of 2017 were the highest of the year. The total 'All-Property' return was 1.80% in the fourth quarter, up from 1.70% in the previous quarter. For 2017, the ungeared annual total return was just below 7%. 'Industrial' property secured its lead for annual total returns (13.07%) with other property types trailing by a wide margin (source: NCREIF, 25 January 2018).

In 2017, the technology sector was once again the largest contributor to national office leasing, ranked by industry. In addition, co-working joined tech and life sciences as a dominant expansionary force (source: Jones Lang LaSalle, Office Outlook, 4Q17). In 2018 and 2019, growth in office occupancy levels will slow as a result of fresh supply. **Indeed, the US office market is expected to see new supply coming onto the market, putting upward pressure on vacancy levels (currently hovering at roughly 15%).** Particularly in the suburbs, the vacancy rate is projected to rise further (nearly 17% as at 4Q17).

We believe capital appreciation returns will slow in the coming months, depending on how fast long-term nominal interest rates climb, and whether real interest rates (adjusted for inflation) soar as well. For foreign investors, the weakening US dollar seen in recent months could be a worry or an opportunity, especially for investors thinking in euro terms. Our Wealth Management economists forecast a rather stable EUR/USD exchange rate of 1.22 in the coming months.

Lower-tiered real-estate markets

We believe 'value-added' will remain the preferred strategy for investors accepting higher risk. Like anywhere else in the world, value creation by asset managers is a prerequisite for boosting IRRs. We maintain our Neutral recommendation on these markets because price growth may level off in view of the more challenging investment conditions.

RESIDENTIAL REAL ESTATE

We are Neutral on US housing markets, even though the latest S&P Dow Jones data on US housing markets revealed decent annual growth in house prices in November 2017, with Seattle (+12.7%) in pole position. Although the housing markets are performing quite well — supported by relatively low mortgage rates hovering at around 4.25% for a 30-year fixed mortgage rate (source: Zillow.com, 2 February 2018) — we project diminishing growth rates for housing values in the near future.

In consequence, favourable factors such as low interest rates may shift somewhat in 2018. As the increase in the Composite-20 was 6.4% in the 12-month period to end-November 2017 — almost three times the rate of inflation rate (2.1% as at December 2017, source: TradingEconomics) — renting may be more attractive than buying in some West coast cities (source: S&P Dow Jones Indices).

Table 6: US house prices (as at 31 November 2017)

Metropolitan Area	Monthly change (%)	Annual change (%)
Seattle	0.2 %	12.7 %
Las Vegas	0.7 %	10.6 %
San Fransisco	1.4 %	9.1 %
San Diego	-0.3 %	7.4 %
Tampa	1.0 %	7.1 %
Dallas	0.1 %	7.0 %
Denver	0.4 %	7.0 %
Detroit	-0.3 %	7.0 %
Los Angeles	0.7 %	7.0 %
Portland	0.0 %	6.9 %
Composite-20	0.2 %	6.4 %
Boston	-0.1 %	6.3 %
U.S. National	0.2 %	6.2 %
Composite-10	0.3 %	6.1 %
Charlotte	-0.3 %	5.8 %
New York	0.2 %	5.7 %
Phoenix	-0.1 %	5.6 %
Minneapolis	-0.1 %	5.4 %
Atlanta	0.0 %	5.2 %
Cleveland	-0.4 %	4.1 %
Miami	0.2 %	4.1 %
Chicago	-0.4 %	3.6 %
Washington	0.2 %	3.3 %

Source: S&P Dow Jones Indices and CoreLogic, 30 January 2018
Annual housing prices, ranked from high to low

There is mounting concern over the growing importance of non-resident, foreign buyers in the US (and in other regions of the world too). These buyers are often very wealthy, with ample means to buy luxurious houses (with no recourse to mortgage financing). Overseas investors sometimes push up house prices, thus elbowing out domestic buyers. This is very similar to the London luxury house markets. Moreover, they can restrict the supply available to other buyers if they leave their houses empty for the best part of the year. Nonetheless, the National Association of Realtors reported that the overall share of existing homes sold to non-resident, foreign buyers in the US has remained relatively small since 2010 though, averaging about 2.2% of sales (National Association of Realtors, 2017 Profile of International Activity in US Residential Real Estate, July 2017).

Two Canadian cities have attempted to minimise the effect that non-resident, foreign buyers have on the market by implementing a 15% tax on their purchases. The new tax on sales was effective on 21 April 2016 in Toronto. "The Non-Resident Speculation Tax is a 15% tax on the purchase or acquisition of an interest in residential property located in the Greater Golden Horseshoe Region (GGH) by individuals who are not citizens or permanent residents of Canada or by foreign corporations (foreign entities) and taxable trustees (source: Ontario Ministry of Finance). Moreover, the speculation tax has been in place in Vancouver since August 2016 as well".

After levying a tax on non-resident foreign buyers in Vancouver, growth in house prices slowed from a fabulous 26% annual rise in August 2016 to 8% in June 2017.

EMERGING MARKETS (EMERGING ASIA & LATIN AMERICA)

COMMERCIAL REAL ESTATE

We are Neutral on selective investments across emerging markets, in both Asia and Latin America. In fact, the emerging markets are very differentiated, and we believe opportunities could also be sought outside the usual core areas.

Obviously investment opportunities exist in Asia, but they pose risks. Rules can still be complicated, requiring the involvement of local partners and a good knowledge of the local language, laws and tax regime.

Actually, many professionally-managed portfolios focus on 'non-core', 'alternative', 'added-value' or 'turnaround' properties. Value-added strategies carry a higher risk-return profile, and a typical value-added strategy consists of acquiring property at a discount to the replacement cost, with a view to generating attractive returns even if the market stays flat. Alternatively, note that gateway cities still offer older assets, which need refurbishing and redesigning to accommodate modern tenants, hence incurring a significant capital expenditure. Project development may also be a consideration.

Some examples of value creation in Asia:

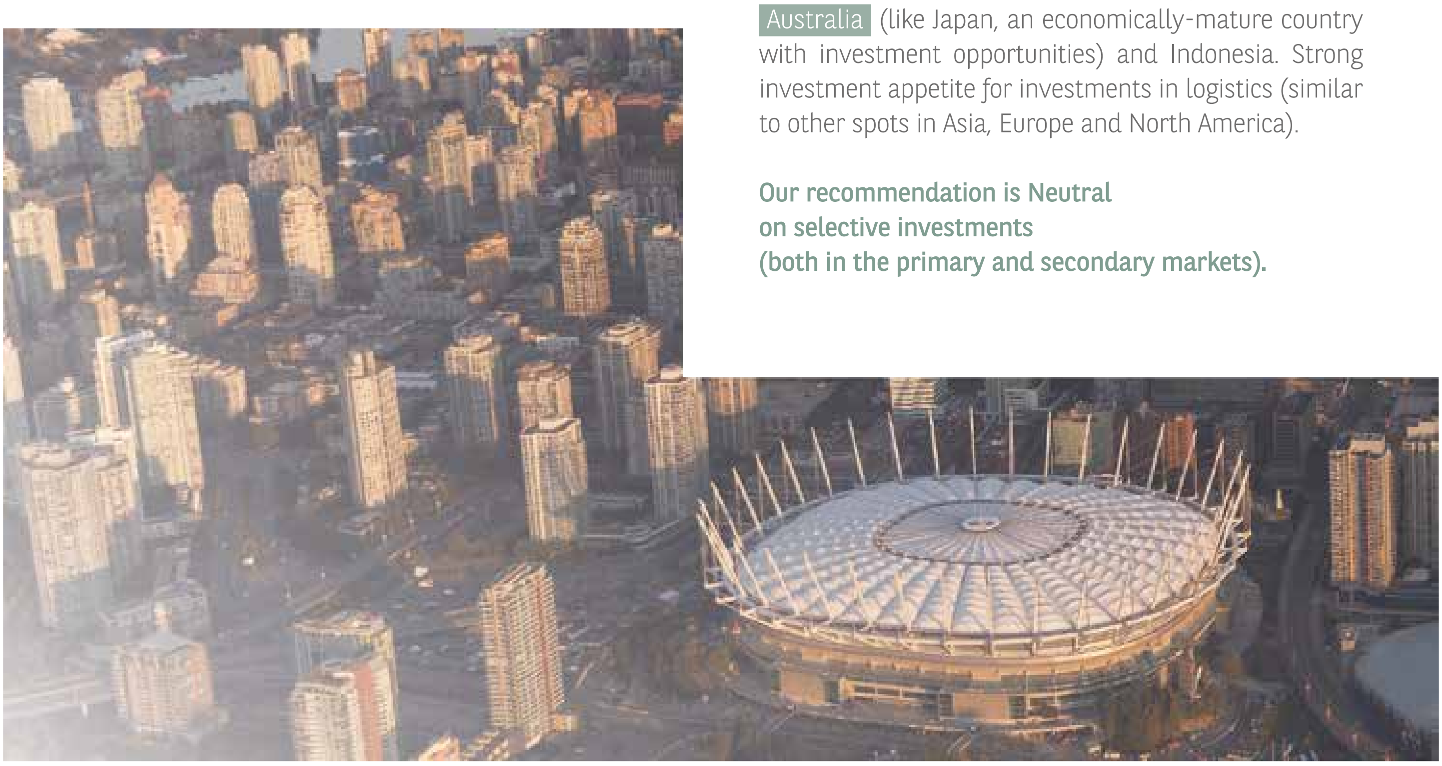
India Real-estate opportunities still exist in India, a country that has underperformed other Asian nations in recent years. There is a general lack of prime office/retail space, and existing retail and office schemes need to be upgraded;

China Even though some caution is appropriate for the Chinese property markets in general, there is a strong investor appetite for the logistics sector (because of growing local e-commerce activity). Investment opportunities may also arise from non-performing loans given the rising debt levels;

Japan The land of the rising sun is an economically-mature country, though investment opportunities could be found in the residential sector. **There is room for enhanced asset management of big property portfolios** (higher rents, lower management fees). Alternatively, commercial assets may be bought by (foreign) private equity players who are capable of making speedy decisions (as opposed to local institutional investors who have lengthy decision procedures). The vacancy rate of 'Grade B offices' in Tokyo stood at a mere 1.9% at the end of 4Q17, with many decreases in sub-markets such as Akasaka,/Roppongi, Shibuya and Nihombashi (source: JLL, Tokyo Office Market Update);

Australia (like Japan, an economically-mature country with investment opportunities) and Indonesia. Strong investment appetite for investments in logistics (similar to other spots in Asia, Europe and North America).

Our recommendation is Neutral on selective investments (both in the primary and secondary markets).



RESIDENTIAL REAL ESTATE

Property In China's Tier-1 and lower-tiered Cities

We are Neutral on property located in China's Tier-1 cities and Positive on lower-tiered property markets.

House prices continued to vary across China in December 2017, with some prime residential markets recording a modest monthly price decline while second- and third-tiered cities enjoyed shy price growth. **Hence, we changed our recommendation for the country's second-tiered markets from Hold to Buy last October.** On an annual basis, the price tag for new houses stayed either flat or fell somewhat for well-established markets such as Beijing, Shanghai and Shenzhen (as at December 2017). Lower-tiered markets enjoyed price increases of 10%: Chongqing, Guiyang, Kunming and Xi'an (source: National Bureau of Statistics of China).

Investors should be cautious about prime cities for the time being, as housing regulations in large cities have tightened since September 2017. Opportunities in 'medium-sized' or 'small' cities could offer better value in the coming months.

What about Singapore?

The residential market was slightly more upbeat in 2017, though caution is still needed. The Urban Redevelopment Authority (URA) released on 2 January 2018 the flash estimate of the price index for private residential property in 4Q17.

Overall, the private residential property index gained 1 point from 137.6 points in the third quarter 2017 to 138.6 points in 4Q17. This represents a 0.7% increase, identical to the 0.7% increase in the previous quarter. For the full year of 2017, prices edged up by 1% versus -3.1% in 2016.

Hong Kong was the least affordable market in 2017 for the 8th consecutive year

(source: The 14th Annual Demographia International Housing Affordability Survey, 22 January 2018). The major housing markets in Australia, New Zealand and China are exorbitant. **Behind Hong Kong, Sydney and Vancouver secured their positions as the 2nd and 3rd least-affordable major housing markets in the survey.** Meanwhile, the 10 most affordable housing markets are all in the US, with Rochester ranking top, followed by Cincinnati, Cleveland and Oklahoma.

Middle East

It was a disappointing year for residential property markets in the United Arab Emirates. **Both prices and rents fell again compared with a year ago, although the villa market in Abu Dhabi started to show signs of a recovery.**

Property prices in Dubai fell by 0.65% month-on-month in October 2017 and by 2.96% y-o-y. A breakdown of figures shows that apartment prices were down 0.68% on a monthly basis and villa prices down 0.51%, and on an annual basis, they fell by 2.96% and 1.36% respectively (source: REIDIN index).

Rents in Dubai are also diminishing. October rents were down overall by 0.74% m-o-m and by 6.27% y-o-y. Apartment rents fell 0.69% on a monthly basis and 6.02% on an annual basis while villa rents were down 0.96% m-o-m and 7.63% y-o-y.

CONCLUSION

WE BELIEVE THAT LAST YEAR'S CHANGE IN RISK AWARENESS WAS MORE 'PSYCHOLOGICAL' THAN 'ECONOMIC' (IN BOTH COMMERCIAL AND HOUSING MARKETS).

But this did not happen because monetary policy remained accommodative in many regions (especially in Europe). Even amid challenging Brexit negotiations, the UK property markets coped pretty well with the uncertainty, ending the year on a positive note. Many private and institutional investors continued to focus on (declining) spreads between net capitalisation rates and risk-free interest rates, rather than on adequate risk premiums. They have been doing this for more than five years, and have been right so far!

So what does the future hold? **Commercial property returns will slow from last year's attractive levels.** Even though occupational markets are in good shape in many economically-mature markets, interest rates — set to rise modestly — may no longer underpin property returns. **Property yields are at threat from rising risk-free rates.** Capitalisation rates should stabilise or move out somewhat, thus logically hampering capital appreciation returns. The same rationale can be used for other housing markets.

Holding a portfolio of real-estate assets spread across segments and countries is relevant for income diversification rather than outperformance. Investors seeking higher returns (IRRs of at least 10%) should aim to capture 'value-added' investment opportunities.

Pol Robert Tansens
Head of Real Estate Investment Strategy - BNP Paribas Wealth Management

Disclaimer:

This marketing document is communicated by the Wealth Management métier of BNP Paribas,a French Société Anonyme with a capital of €2,497,718,772, Head Office 16 boulevard des Italiens, 75009 Paris, France, registered under number 662 042 449 RCS Paris, registered in France as a bank with the French Autorité de Contrôle Prudentiel (ACPR) and regulated by the French Autorité des Marchés Financiers (AMF). As marketing material, it has not been prepared in accordance with legal and regulatory requirements aimed at ensuring the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination.It has not been submitted to the AMF or any other market authority.This document is confidential and intended solely for the use of BNP Paribas SA, BNP Paribas Wealth Management SA or their affiliates ("BNP Paribas") and the persons to whom this document has been delivered. It may not be distributed, published, reproduced or disclosed by any recipient to any other person, nor may it be quoted or referred to in any document, without the prior consent of BNP Paribas. This document is provided solely for information and shall not constitute an offer or solicitation in any state or jurisdiction in which such an offer or solicitation is not authorized, or to any person to whom it is unlawful to make such offer, solicitation or sale. It is not, and under no circumstances is it to be construed as, a prospectus. Although the information provided herein may have been obtained from published or unpublished sources considered to be reliable and while all reasonable care has been taken in the preparation of this document, BNP Paribas does not make any representation or warranty, express or implied, as to its accuracy or completeness and does not accept responsibility for any inaccuracy, error or omission. BNP Paribas gives no warranty, guarantee or representation as to the expected or projected success, profitability, return, performance, result, effect, consequence or benefit (either legal, regulatory, tax, financial, accounting or otherwise) of any product or transaction. Investors should not place undue reliance on any theoretical historical information regarding such theoretical historical performance. This document may contain or refer to past performance; past performance is no guarantee for future performance. The information contained in this document has been drafted without prior knowledge of your personal circumstances, including your financial position, risk profile and investment objectives. Prior to entering into a transaction each investor should fully understand he financial risks, including any market risk associated with the issuer, the merits and the suitability of investing in any product and consult with his or her own legal, tax, financial and accounting advisors before making his or her investment. Investors should be in a position to fully understand the features of the transaction and, in the absence of any provision to the contrary, be financially able to bear a loss of their investment and willing to accept such risk. Investors should always keep in mind that the value of investments and any income from them may go down as well as up and that past performance should not be seen as an indication of future performance. Any investment in a product described herein is subject to the prior reading and understanding of the legal documentation concerning the product, and in particular the ones which describe in details the rights and obligations of investors as well as the risks inherent to an investment in the product. The main risks linked to a real estate investment are the following ones:

- **Liquidity risk:** For a real estate investment, the liquidity is the possibility to sell rapidly the underlying asset or the asset directly held, without affecting its price. According to their characteristics, real estate assets have varying degrees of liquidity.
- **Yield risk:** Depending on the macro-economic, financial and fiscal, environment of the asset, the performance of a real estate investment may vary unpredictably over time.
- **Financial risk:** The change in interest rates, inflation and credit access conditions constitutes the financial risk of real estate investments.
- **Economic and rental risks:** The performance of real estate investments is closely linked to tenants' demand, purchasing power and solvency. Tenants represent both default risk and vacancy risks.
- **Risk related to the location:** A real estate asset is exposed to the risk of depreciation of the location that may directly affect its value or yield (town planning, projects to enhance the value of the area or not, quality of the neighbourhood ...)
- **Real estate risk:** Real estate assets are subject to a risk of obsolescence that may have an impact on the building's capacity to generate income over time (rental risk). The obsolescence risk is higher today in the face of the appearance of new environmental norms.
- **Capital risk:** Real estate assets cannot be guaranteed and, when selling his/her real estate investment, an investor may suffer from partial or total loss of the capital initially invested.
- **Changes in the legal, regulatory and tax environment:** Any changes of a legal, tax or regulatory nature occurring during the life of a real estate fund may have detrimental effects on the performance of the fund itself or its investments.

Save as otherwise expressly agreed in writing, BNP Paribas is not acting as financial adviser or fiduciary of the investor in any transaction. The information, opinions and projections expressed herein reflect the opinion of their author at the time of writing; they are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by anyone, and are subject to change without notice. Neither BNP Paribas nor any BNP Paribas Group entity accepts any liability whatsoever for any consequences that may arise from the use of information, opinions or projections contained herein. As distributor of the products described herein, BNP Paribas may receive distribution fees on which you can obtain more information upon specific request. BNP Paribas, its employees or administrators may hold positions in these products or have dealings with their issuers.

By accepting this document, you agree to be bound by the foregoing limitations.

Pol Robert Tansens, MRICS
Head of Real Estate Investment Strategy
BNP Paribas Wealth Management
Email: pol.tansens@bnpparibasfortis.com

Director of Publication:
Claire Roborel de Climens
Head of Private Investments and Real Estate
BNP Paribas Wealth Management
Email: claire.roboreldeclimens@bnpparibas.com

BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world