"THE SKY'S THE LIMIT". BUT IS THIS STILL TRUE FOR TODAY'S REAL-ESTATE MARKETS?

BNP PARIBAS
WEALTH MANAGEMENT

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Highlights of the report

The past can be used to suggest many things, with history believed to repeat itself. Some examples:

"Property values will fall if interest rates rise". Which interest rates? Nominal rates? Real rates? What type of property: prime or secondary? Which areas?

"Property cycles are linked to economic cycles". Is the relationship between economic fundamentals and real estate performance clearly defined? Are capital markets capable of distorting this linkage? Has property management progressed more professionally in recent years, allowing for better performances anyway?

"UK property markets will suffer a disastrous slump due to Brexit as they did in the early nineties." Are UK interest rates hovering at similar levels presently? Can the impact of Brexit – based on facts – be fully assessed today?

We believe history will not necessarily repeat itself by following a standard pattern. But one cannot ignore that both occupational and investment markets react to events with a lot of media coverage – such as Brexit - and economic data (instantly or with a time lag). In short, some evidence of property cyclicality may eventually emerge. ***We are of the opinion that it is too dangerous for investors to assume that "cycles are a thing of the past", making valuation multiples less relevant.***

This year appears to be more uncertain for property investors. It is too early to say whether the various real estate markets are nearing a tipping point, ready for re-pricing

Which measurable indicators of a change in risk sentiment swept across the property markets in 1H16?

- **European commercial real estate volumes.** CBRE European Investment Quarterly, 2Q16), with Europe's two largest markets – the UK and Germany – losing steam, though for various reasons. The UK showed a slowdown in commercial real estate investment in the first half of 2016, registering a 45% decline from a year earlier (source: Real Capital Analytics). In Germany, prime property has become a scarce commodity.

- **Commercial property markets in the UK** had already been affected in the run-up to the Brexit vote, and a weak property performance was apparent in July, the first month after the referendum. As a matter of fact, lower investment volumes translated into capital losses. For example, office values in the

City of London fell by 6%, sacrificing equity appreciation returns even more (depending on leverage, source: CBRE United Kingdom Monthly Index of July 2016). In addition, Norway's sovereign wealth fund did not await convincing property data to revise down the value of its UK holdings by 5% in the second quarter. And the Brexit outcome was very tough for the UK's open-ended property funds, as 7 large property vehicles had to suspend trading almost straightaway amid volatile market conditions.

- **The performance of the world's major housing markets** is dispersed to an increasing extent, marking a differentiated price pattern. Hong Kong's overvalued residential market saw property prices tumble by around 30% between October and July 2016 (depending on sources). Singapore's mature housing market continued to erode as well, albeit in a "controlled" way. Alternatively, Chinese housing prices soared in 55 of 70 medium and large-sized cities in June 2016, but the markets remain "tiered", as did growth in housing prices. In Latin America – and especially in economically-battered Brazil – housing prices do not offer any protection against inflation, contrary to popular believe. In Rio de Janeiro, the local real estate market plunged by over 12% in real terms in the year to end-July 2016 (source: FipeZap index). In contrast to average housing prices across the US that posted year-on-year gains of about 5% in May 2016, easily outpacing inflation levels (source: Standard & Poor's CoreLogic Case-Shiller home price index). And Europe would not be Europe if the housing market was not fragmented altogether. London's high-end real estate prices have become seriously under pressure in recent months. Notwithstanding, it is difficult to ascertain whether price declines resulted from a higher stamp duty or waning risk appetite from international investors, causing a bandwagon effect. Maybe all factors come into play.

  In April 2016, annual investment volumes were 19% higher in France (source: Notaires de France), even though investment appetite did not lift prices significantly higher until this point. And an "unknown" country like Sweden reported a fabulous 12.1% increase in real housing prices in the year ended 31 March 2016, which was the result of negative interest rates. In Spain, housing values have been edging up for 2 years, yet housing transactions fell in 2Q16 given a couple of challenges;

- Many of the **mature economies** have developed **commercial and residential property markets**, with large institutional investors and a structural oversupply of capital. This "wall of capital" may chase too few real estate assets, leading to high prices and low gross initial yields. But it is increasingly disturbing that diversification through investments in emerging markets does not smoothly translate into higher returns for any incremental risk incurred (for instance currency effects), whether in the Middle East (Dubai), Latin America (Brazil and neighbouring countries) or Asia (weaker capital growth rates in many areas);

- Renewed volatility in the **listed Real Estate Investment Trust (REIT) markets** reached a climax on 24 June 2016, with UK REITs diving by 14% in the pound on the same day. Losses widened in "stronger" currencies like the US dollar and the euro. However, price declines were very uneven (between the UK on the one hand and Continental Europe, the US and Asia on the other). Manifestly, there was no reason for investors to panic.

A current swing in risk sentiment is possible, with the risk-pricing pendulum switching in favour of "fear". We nevertheless believe investors may survive the latest challenges, as conditions are still conducive to property investments:

- **Nominal (and real) interest rates** have been edging lower, again, since the publication of our previous property report in April 2016. Although a market overheating may be a threat, lower long bond yields enabled gross initial yields to remain stable or compress marginally in 1H16, as observed in Europe and the US. Our conclusion is that real estate pricing is beefed up by comparing real estate capitalisation rates with risk-free long-term interest rates. This pricing comparison may look ridiculous, but it is not. Property is a true asset class, and institutional and individual investors increasingly look at real estate in relation to equities, bonds and alternative investments. Obviously, real estate is very different from other asset classes for a number of reasons: a) property may be a physical asset; b) revenue from real estate is governed by reasonably long contracts (certainly in the UK), and rents are expected to increase through indexation (to upcoming inflation) or rent reviews. This is a key factor for investors today; c) the supply of property is somehow regulated by various authorities (construction permits, fiscal regulations).

- **The performance of real estate**, as different as it may be, is ultimately linked to the performance of capital markets. The good news is that our economists are projecting interest rates to remain steadily low for a prolonged period, certainly in Continental Europe, the UK (given the interest rate cut by the Bank of England on 4 August), Japan and other regions of mature Asia (including China). Although monetary policy in the US is diverging from other regions, with an interest rate hike on the cards before year-end, rates will remain very low in absolute terms thereafter. The wall of money needs to be invested in the end, even if investors temporarily allocate their cash elsewhere. Reasonable debt-enhanced equity real estate returns are still possible;

- Some **property markets** can benefit from turmoil at the expense of other markets, paving the way for new investment options. This can be said of capitals in Continental Europe (Frankfurt, Dublin, Paris, Luxembourg, etc.) with respect to London or the overall mature markets (the US, Europe including the UK and mature Asia like Australia) in relation to specific emerging market countries. In particular Asian owners are likely to continue their expansion into promising commercial and residential real estate markets, often supported by beneficial government regulations (e.g. Golden visa rules for residential investments in Southern Europe, fiscal rulings for commercial property);

- The volatility of **property shares (REITs)** is higher than that of the physical real estate markets, at least in the short run. But REIT markets are similarly governed by key fundamentals such as the intrinsic value of the underlying properties (through implied capitalisation rates) and external drivers like low interest rates, inflation prospects and the health of the capital markets. As a consequence, REIT total returns tend to mirror those of direct markets, at least in the long run. The day after the "Leave" vote, share prices of REITs fell (in an unequal manner) before quickly recovering afterwards. In Europe excluding the UK, Asia and the US, any "Brexit" losses reported on the blackboard right after the referendum have been wiped off since (as at 6 September 2016) because fundamental parameters – such as very low interest rates – have not altered at this point.

Our real estate investment strategy for long-term investors with a growth and/or income investment objective

- ***Investors with little appetite for risk could invest in commercial and residential core/prime assets in Continental Europe, even though they will need to accept fairly low income returns from these assets (single-digits)***. Unfortunately, capital gains may be virtually non-existent in the coming years, with gross initial yields teetering on the brink of very low levels. Investments could become the "traditional" way by purchasing physical assets. Although these investments are not liquid and often require high amounts of capital, they are generating a higher (indexed) cash yield compared with other asset classes like investment-grade bonds. Furthermore, solid properties would help owners to "weather" any real estate downturn in a (very unlikely) worst-case scenario. Secured income streams would be paramount to offset (unrealised) fluctuations in capital values in such a scenario. We favour Continental Europe over the US as North America has been advancing somewhat further on the property cycle while US dollar-denominated investments are expensive for international investors given the strong greenback.

- ***Investors who do not shun "reasonable" risk have another attractive option. They can invest in private equity real estate funds which pursue a value-added strategy when making property investments in the "primary" as well as "secondary" real estate markets***. Adding value entails buying property, improving them one way or another (physical upgrade, better management, resolving capital constraints, etc.) and selling them once sizeable capital gains can be booked. In addition, value can also be created through purchasing trades (of interests in other property funds) on the secondary market at attractive discounts. As these investments have a "private equity" style and are illiquid, total returns should be double-digits to compensate for any additional risk taken. The investment league can be extended to the UK because Brexit will eventually lead to fresh investment opportunities. To cite but one example, New York-based Madison International Realty contacted several open-ended property funds that froze redemptions in order to take advantage of any downturn in the UK market (source: Financial Times, 11 July 2016).

Our property report examines in more depth the trends and forecasts of commercial property markets, with specific attention to listed real estate. We also look at how the global housing markets are trending at this moment, with a specific focus on the UK, France, the Iberian peninsula, China, Singapore, Hong Kong, the US, Brazil and Dubai.

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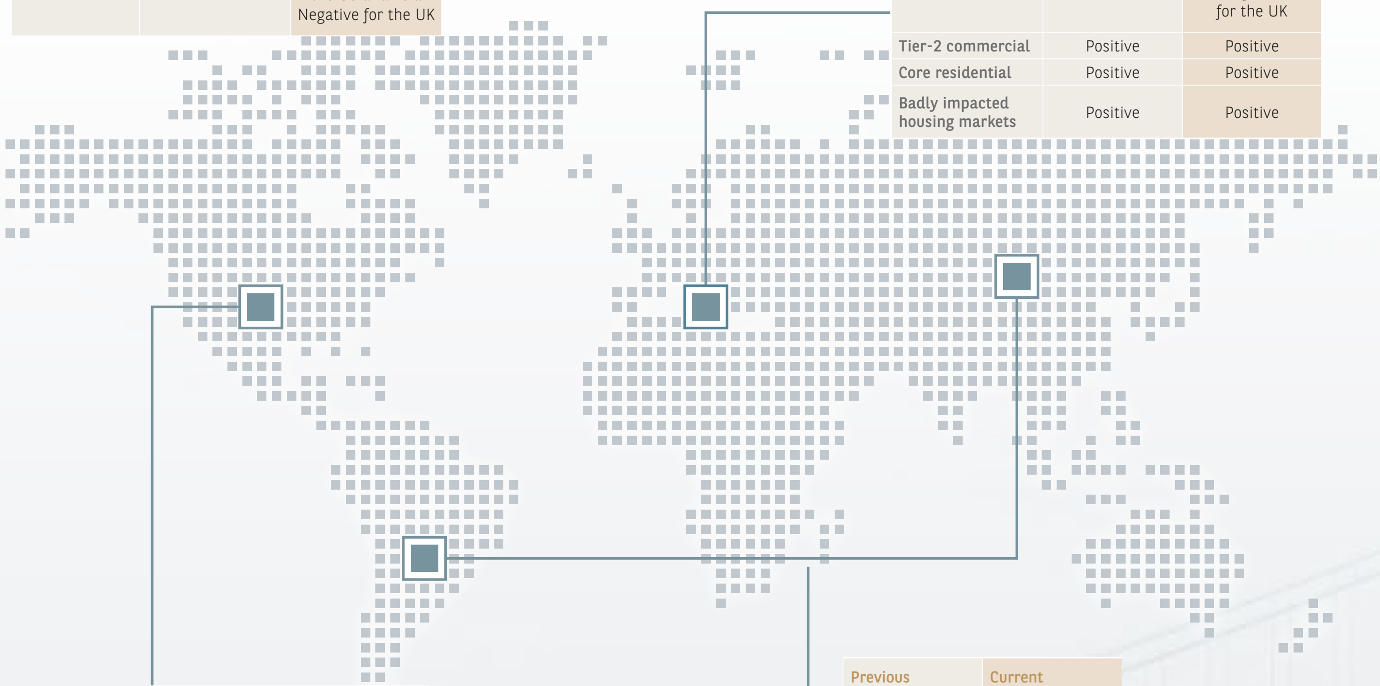
	Previous assessment	Current assessment
Property stocks	Neutral	Positive for Continental Europe Neutral for the US and Asia Negative for the UK

Europe	Previous assessment	Current assessment
Prime commercial	Neutral	Neutral for Continental Europe. Negative for the UK
Tier-2 commercial	Positive	Positive
Core residential	Positive	Positive
Badly impacted housing markets	Positive	Positive



North America	Previous assessment	Current assessment
Prime commercial	Neutral	Neutral
Tier-2 commercial	Positive	Neutral
Residential	Neutral	Neutral

Emerging markets (emerging Asia & Latin America)	Previous assessment	Current assessment
Commercial	Neutral	Neutral
China Tier-1	Positive	Positive
China Tier-2	Negative	Negative
Latin America	Neutral	Negative

Our real estate strategy in brief

Europe

Commercial real estate (CRE)

Tier-1 real estate markets (prime real estate)

We maintain our neutral stance for prime assets as we believe they can still play a significant role within a strategic asset allocation process.

They have certainly done in recent years, in spite of demanding valuations and a lack of available products (in some capital cities). The allocation of European countries to core investments may be somehow arbitrary, and is conditional to product sourcing. As such, we do not favour a so-called "Top-down investing investment approach" that looks first at the overall picture of the economy before breaking down the various components and selecting specific assets. Finding top deals across Europe (France, Germany, Southern Europe, Scandinavian countries) is more relevant today.

However, core markets do have a benchmark: they should be stable and have a stable currency. So broadly speaking, the UK – and in particular London – should be avoided as a prime investment market. Investment volumes had tumbled in the run-up to the Brexit vote, whereas the pound dived against the dollar and the euro in the referendum's aftershock. But above all, capital values for offices started declining in July. Although the correlation between investment volumes and values is often unclear (subject to time lags for instance), we believe investors may be perturbed by fresh losses in the coming months, maybe a further 10% of overall property values which would exacerbate losses for equity appreciation returns (depending on leverage). So we could be at the beginning of a downswing.

As always, pioneer investors could soon detect new investment opportunities across the UK at more reasonable prices (expressed in sterling). For this reason, the UK real estate market should be viewed more as a "value-added" play for the time being.

We reiterate our recommendation to cap the cost of borrowing at a level below net rental yields (net rents after operating costs).

Tier-2 real estate markets

Property markets are segmented according to the location (capital cities and regional cities, differentiation of areas within capitals) and quality of the product (trophy assets vs. refurbishment and conversion of properties for instance). So real estate markets are "tiered", with "tier-1" areas being very expensive and "tier-2" areas offering "value". Tier-2 markets – "next-to-prime" may be a better definition – still offer value today. Fund managers are screening the investment universe to spot owners who are willing to sell their properties "off-market" (without using estate agents). "Off-market" deals can mean less competition and involve a "quick" sale (for cash-rich investors/fund managers). Alternatively, investors could investigate local markets for deals that are "in the market" and yet off the radar for institutional investors (because of the lack of size for instance). In any case, investment managers should never comprise on specific pre-deal investigations and analysis procedures (often referred to as due diligence), whether opportunities are found in or outside the market.

Value could build up as a result of many actions (often taking place simultaneously): physical upgrade of buildings before selling up, conversion of properties (ugly offices in loft apartments for example), enhanced asset management (selection of new tenants), cash injections in debt-burdened buildings, restructuring of vehicles where properties are lodged, etc. Although the investment focus should be geared towards drivers creating value, enabling capital gains upon exit, cash income could also constitute part of the overall equity return.

Similarly to our stance on prime assets, we are not developing any "top-down" approach. On the contrary a "bottom-up approach" – drawing on deal execution skills to originate value – is more pertinent. *Consequently, the UK should not be ruled out from any value-added investment strategy (as opposed to a prime asset play). Target Internal Rate of Returns should be in double-digits to compensate for the higher risk borne and are likely to hover in the early double digits as discounts are narrowing.*

In addition to investments in the overall physical market, investment managers could also attempt to acquire stakes in other property funds that are traded in the secondary market (at a discount). Transactions regularly arise from investment players who need to adjust their investment strategy or want to dispose of interests in property funds for whatever reason (sometimes at a loss).

Residential real estate

We are positive on Europe's core housing markets, even though the difference in European house prices has been accelerating in recent months.

Several observations can be made. First, the interconnection between housing values and investment volumes has been ambiguous until now. In France, annual investment volumes were similar to pre-crisis levels as at end-April 2016, but in essence, the rebound in prices has been modest or uneven (source: Notaires de France). The Belgian coast saw transaction volumes climb by up to 50% in the first half of the year, though prices of apartments and houses stayed flat (source: La Libre Belgique Immo, 18 August). In Spain, annual housing volumes increased by over 20% in the year to end-March 2016, but fell by 10.2% in the first quarter of the year (source: Ministry of Development). Generally speaking, prices are lagging volumes, but the question is how long will this last?

In the UK – like commercial real estate – residential prices have been under pressure. This became pretty obvious in the high-end housing market, for which prices started to decline well ahead of the Brexit referendum. Initially, prices began to erode because of the higher amount of stamp duty last April. It remains to be seen how the "affordable" housing markets will be affected eventually. Housing prices fell by 1% in July following the vote to leave the EU (a survey from Halifax, Britain's biggest mortgage lender). Given the very low interest rates, and insufficient supply levels for housing units at reasonable prices, we do not predict a sudden crash for affordable housing in London. But prices may lose a few more percentage points in 2017 anyway (or be gridlocked at best).

Consequently, we see more potential for purchases in Continental European cities for the time being (Benelux, France, Germany, etc.).

Residential investments are providing a tangible cushion for investors' wealth (whether for owner-occupiers or for landlords renting out). And this should be the first investment rationale. Nevertheless, it may be somewhat laborious to beat inflation levels – albeit very low today – in the coming months, with capital values a little "rigid" in a number of countries. Beyond compare, existing attractive financing conditions (affordable monthly mortgage instalments, refinancing options) appear to be important key drivers for value preservation.

There are exceptions, with housing markets having accumulated much more value in recent years than what inflation would have suggested. Sweden's housing prices exceeded inflation by 12.1% in real terms in the year ended 31 March 2016 (source: Global Property Guide GPG), and we believe the negative yield on long-term sovereign bonds has been a remarkable "external" parameter for (overheated) growth in the country's housing values. Obviously, recovering residential markets has beaten inflation as well over the past 2 years (Spain, Ireland) although these countries were badly impacted by a slump in housing prices in 2008-2010. As the saying goes: "you can't compare apples to oranges".

So we remain positive on Europe's improving housing markets (Spain, Portugal, the Netherlands, Ireland) except Greece. And we warn investors that the biggest price hikes may be behind us (Ireland, possibly Spain)

North America

Commercial real estate

Tier-1 real markets (prime real estate)

We maintain our neutral view on prime real estate for the US markets.

Capital growth rates were still remarkable for the second quarter, "All Property" carrying an unlevered total return of 10.64% (source: NCREIF). But capital growth rates are expected to deteriorate in the coming months, as this is already evident right now, with pension funds in the US increasingly pulling capital out of the country's large open-ended property funds. The JP Morgan Strategic Property Fund alone has received USD 1bn (EUR 888m) in requests so far this year, while PRISA I, managed by PGIM Real Estate, has received USD 700m (source: IPE Real Estate, 24 August 2016). An additional risk consists in a further tightening of the monetary policy by the Fed before year-end.

Tier-2 markets

We change our recommendation from Buy to Neutral, as the price growth may come to an end. For overseas investors, the strong US dollar is making local real estate more expensive, which is a competitive disadvantage for the US.

Residential real estate

We are Neutral on the US housing markets, although the latest data of S&P Dow Jones on the US housing markets divulged still higher annual housing prices in May 2016, with Portland and Seattle being in pole position. Even though housing is doing quite well – supported by the relatively low interest rates (below 4% for 30-year mortgages) – we are projecting diminishing growth rates for housing values in the near future. Our story is comparable with what we have said about commercial real estate.

Emerging markets
(emerging Asia & Latin America)

Commercial real estate

Prime real estate

We are Neutral on selective investments across the emerging markets, in both Asia and Latin America.
We have always considered extra return opportunities as a first rationale for investing in the emerging markets. Prospects of better return opportunities may be structural (growing middle-class populations, economic development, favourable demographics and the like). Or return opportunities may be of a cyclical nature (opportunities for market timing). Unfortunately, from a European/American point of view, diversification into emerging markets has not always produced the expected total returns for the risk taken. Latin America is a good example, with Brazil severely suffering and currency effects dampening local property returns. The vicious downward spiral of depreciating (commodity) currencies nevertheless seems to have halted, with a number of emerging market currencies having appreciated somewhat in recent months (against both the US dollar and the euro). In Asia Pacific, investment volumes fell by 5% last year (source: Jones Lang LaSalle). In China, some development schemes have not produced the desired effects for investors whereas India's property markets have showed a lacklustre performance over the past few years. Hong Kong's high street rents may fall a further 10 to 15% this year.

Of course we acknowledge that property growth drivers remain fundamentally different (more positive) from other economically advanced regions, yet this will not automatically lead to (much) higher returns at this stage. There is still an additional risk involved. Generally speaking, Asian and Latin American property markets are affected by weaker growth in capital appreciation returns and the risk of an oversupply. Growth is steady but declining.

Some Asian "mature" markets have not been performing well, as evidenced by Singapore, where office rents fell by 13% in the year to end-March 2016 (source: Jones Lang La Salle). Other countries, like Japan, were put back on the investors' radar, pushing up prices (especially in Tokyo). But investors are now wondering whether Abenomics will eventually bring back economic growth and inflation on a sustainable basis. Can gross initial yields carried by commercial property fall much further in Tokyo? We do not think so. Australia in contrast has been performing well in the year to end-March 2016, with office rents soaring by 13% (source: Jones Lang LaSalle). But rents and capital values are projected to grow at less ambitious rates in the months ahead.

Our recommendation is Neutral for selective investments. Asia and Latin America are vast continents that are hugely differentiated property-wise, i.e. very similar to Europe. As a consequence, investors should seek advice from experienced fund managers/analysts to explore local markets and identify investment opportunities, with total returns mildly exceeding those booked by similar investments in Europe and North America. Unsurprisingly, deal execution skills and due diligence procedures are also important in this part of the world.

Residential real estate

Property in China's Tier-1 cities

We remain positive on property located in China's Tier-1 cities. China's new house prices continue to soar in June 2016 on a monthly basis. Hot spots are Shenzen, Xiamen, Nanjing, Shanghai and Beijing. But the overall Chinese housing market is a double-tiered market: Tier-2 and tier-3 markets still lost some value over the same period. For this reason, we are recommending investments in prime markets only.

We change our recommendation for Latin America's housing markets from Neutral to Sell, in particular for Brazil. In this country of the Samba, investors in residential real estate have not been shielded from the high inflation in recent months, losing almost 9% in real terms in the year ended 30 June 2016 (source: FipeZap index). What's more, nominal housing prices are set to decline as well in the coming months given the harsh economic (and political) conditions in this country. Currency movements across Latin America remain a risk for overseas investors in spite of some appreciation seen in recent months (e.g. +27% on 3 August 2016 for the Brazilian real since historical lows, source: Bloomberg).

Listed real estate

There is no doubt that REITs have offered international investors excellent potential to access real estate markets in general and enjoy attractive annual total returns (+6% for global listed real estate in the 10 years to end-August 2016, source: EPRA).

Property shares have higher volatility compared with the direct property market. UK REITs slumped by a staggering 14% (in sterling) on 24 June 2016, the day after the referendum, a wake-up call for many investors. A projected decline in real estate values can rapidly translate into share prices of liquid REITs. Nonetheless, REITs in other regions (Continental Europe, North America, etc.) reacted less aggressively on that day.

Share prices of REITs have since rallied, posting reasonable total returns in July and August 2016 (for example +6.25% for the FTSE EPRA/NAREIT Eurozone index in the three-month period ended on 8 September, source: EPRA). This is somehow logical because the supportive drivers of REITs have not disappeared over time: zero-interest rates and the subsequent spread of 300bp with gross average dividend yields. UK REITs were the sole exception to the recovery given the change in the local occupier markets (-11.85% for the FTSE EPRA/NAREIT UK index in pound sterling over the same period, source: EPRA).

We keep our positive recommendation for Continental European REITs, how astonishing this may be. Monetary policy remains a key driver. We now turn negative on UK REITs, as share prices may fall again in view of expected losses in capital values. We keep our neutral recommendation for US and Asian REITs. In North America, benchmark interest rates are projected to be raised once this year by the Fed (twice next year) whereas Asian REITs (including Japanese REITs) may not outperform due to weaker capital growth rates projected for a couple of occupational markets.

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- **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.

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