SETTING UP A EUROPEAN OFFICE STRATEGY FOR ASIA-BASED INVESTORS

In this short paper we set out the case for European office investment for Asia-based investors. The report is specifically focused on the benefits of such investment for BNP Paribas REIM clients.

EXECUTIVE SUMMARY

Our research strongly supports investment in a portfolio of European diversified core/core+ offices. There are three main arguments supporting our view:

- The European office sector is large and liquid
- European offices are likely to provide high diversification benefits to Asian investors
- European offices are generally higher-yielding than Asian offices

Timing is also important as investors may benefit from a combination of different positive factors supporting investment, namely a very high historical yield gap over bonds which provides some protection against the risk of a future rate increase, very attractive financing conditions and positive impact of leverage, new supply of office space at historical lows. Finally, the outlook for the European economy is slowly, but constantly, improving and, as a result, there is a fair chance of rental growth for some markets, and, consequently of higher returns.

Which investment strategy to choose depends largely from investors' attitudes and preferences. We tend to think that in order to deliver relatively solid returns and capital preservation, investing in attractive, high-quality, well-located, core/core+ property still represents a viable strategy, especially when taking into account the fact that European monetary policy is expected to stay loose for some time. While potential returns from office investment are undoubtedly lower when compared to a couple of years ago, as a result of strong yield compression, this investment style is more defensive in the case of an unexpected correction.

Our preferred office markets are economies containing large, high-growth, office-using industries such as professional/business services, high-tech and healthcare. These markets are also generally characterised by high levels of liquidity. Examples include most of the European office markets as described later in this paper.

1.0 THE BENEFITS OF A EUROPEAN DIVERSIFIED OFFICE PORTFOLIO

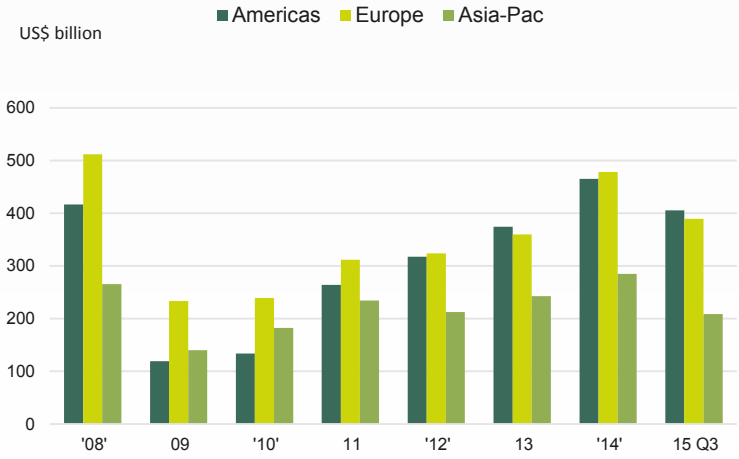
The case for European office investment is compelling for a number of reasons. Most of these markets have some features that are indeed appealing to investors. There are three main arguments: the sheer size of the European market, diversification and the range of opportunities potentially offering relatively high returns.

1.1 SIZE AND LIQUIDITY OF THE SECTOR

First, European property markets are sizeable and diverse. The total size of European institutional-quality property at end-2014 is estimated by IPD at around US$2.5 trillion, roughly equivalent to the size of the US market. Office is the largest sector and makes up more than 40 percent of the institutional-quality European real estate market, some US$1 trillion. It is difficult to compare these figures with the Asian equivalent, as IPD publishes data only for Japan and South Korea in these countries. However, it is sufficient to note that the size of the Japanese office market, the largest and most institutional in the Asian continent, is around US$290 billion, mostly located in Tokyo.

Office assets are also the most transacted type of real estate[1]. Europe is the largest area in terms of transactions, while Asia Pacific is the smallest (Chart 1). As a result, overall, it can be argued that, overall, European offices are relatively liquid from an investor's perspective.

Chart 1: Real estate transactions



Source: RCAnalytics

1.2 DIVERSIFICATION BENEFITS

In a multi-country allocation, the risk/return of a portfolio can be improved by exploiting low or negative return correlations in different countries, related to a different rental and capital cycle. Moreover, a multi-country portfolio provides diversification across the various geographies and economic bases in which the assets are located. Multi-tenanted buildings add a further dimension of diversification. As performance data for Asian markets is limited in scope and data length, we have decided to use national GDP growth rates, which, among other things, allow us to use long time series and, therefore, look at different cycles. Table 1 shows GDP cross-correlations for the five largest European economies and the most important Asian countries in terms of real estate investment. Most Asian economies are weakly correlated with their European equivalent which bodes well for an Asian investor looking for portfolio diversification (the numbers in green show the lowest correlations).

Table 1: GDP cross-correlations

	China	Hong Kong	Japan	Korea	Singapore	Taiwan
France	0,0	0,3	0,6	-0,2	-0,2	0,5
Germany	0,2	0,6	0,9	0,2	0,4	0,7
Italy	0,3	0,5	0,7	0,4	0,5	0,7
Spain	0,1	0,3	0,5	0,2	0,1	0,5
UK	0,1	0,3	0,5	-0,2	-0,1	0,3

Source: IFM

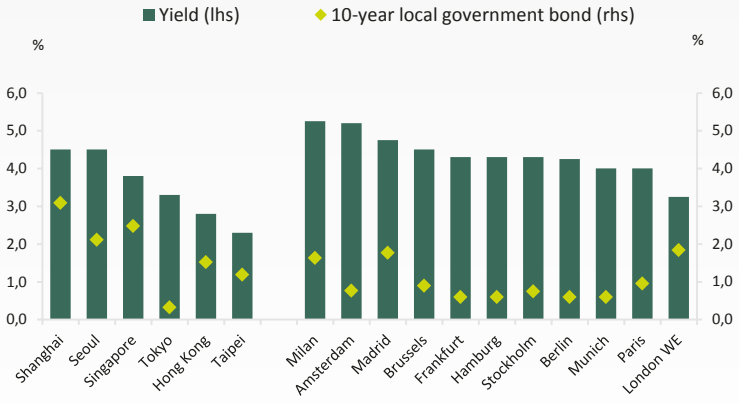
[1] *Over the last 9 years, on average office transactions represented around 40% of total real estate transactions in Europe, according to RCAnalytics (including residential but excluding land transactions).*

1.3 INCOME AND TOTAL RETURNS

Another rationale for investing internationally is the range of opportunities available to a foreign investor, along with the attractive returns that are available. While it is true that GDP growth is generally expected to be higher in Asia, European markets have historically yielded high real estate returns. Planning constraints in most European markets are often quoted as a determinant of property outperformance. New supply in Europe is more constrained, resulting in less dramatic cycles and supporting rental values.

Ultimately, core/core+ real estate is primarily an income-oriented investment, supplemented with the opportunity for capital appreciation. Overall, and with the exception of few markets, yields are higher in Europe when compared to Asia. Moreover, for most markets, the premium (the difference between prime office yields and 10-year government bonds) is also higher in Europe (Chart 2).

Chart 2: Prime Office yields in Europe and Asia[3]



Source: BNP Paribas Real Estate, CBRE, Bloomberg

2.0 CURRENT TRENDS IN EUROPEAN OFFICE MARKETS

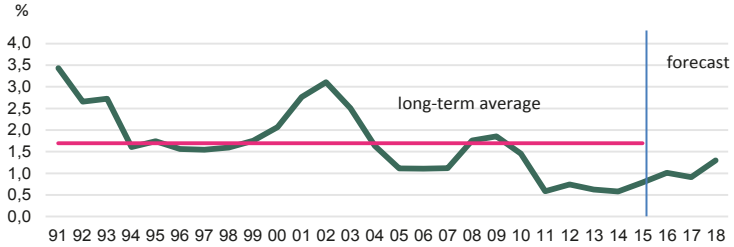
2.1 PRICING REMAINS SUPPORTED BY A NUMBER OF FACTORS

While current office yields in some European markets are at historically low levels, their spreads to long-term bond yields are nonetheless near historic highs. This is a result of the combination of the "normal" real estate risk premium vs. the so-called risk-free asset[4] along with an exceptional premium related to the currently artificially-low level of bond rates, which creates an extra-protection for investors in case of rate increases. Moreover, source of capital targeting European real estate are expected to stay strong as both domestics and increasingly cross-border investors chase opportunities, therefore providing upward pressure to pricing.

2.2 NEW SUPPLY OF COMMERCIAL REAL ESTATE IS AT RECORD LOWS

The supply picture is also supporting improvements in the market balance. The near-term office pipeline remains relatively weak by historical standards. Developers are still cautious, and tend not to start building unless a significant pre-let is secured before (Chart 3).

Chart 3: Net additions to stock



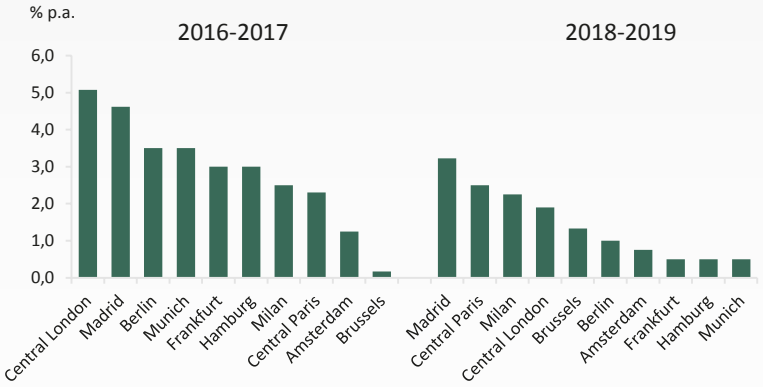
Source: BNP Paribas Real Estate, CBRE, Bloomberg

[3] Office yields are for Q2 2015.
[4] In Europe the risk-free asset is normally represented by the German government bond yield.

2.3 SOME RENTAL GROWTH IS EXPECTED

The European economy is steadily improving and employment growth will follow suit. As a result, some rental growth is expected, although this will vary from market to market. However, some risks to the economic outlook still exist and rental growth is, as a consequence, at risk. Specifically, in the short-run, London is the clear leader, along with Madrid and Germany. However, we anticipate that, as Continental Europe's economy recovers, Madrid, Paris and Milan should out-perform from 2018, while growth in London is expected to subside (Chart 4).

Chart 4: Rental growth forecasts



Source: BNP Paribas Real Estate

2.4 FINANCING CONDITIONS ARE ATTRACTIVE

Banks' appetite for real estate lending is steadily improving. Lately, increasing competition for business has resulted in lower margins and, therefore, lowering costs while LTVs are becoming higher. Furthermore, some banks and namely the ECB will likely keep policy rates low for an extended period of time. As a result, despite lowering office yields, income returns are also attractive as a result of the positive impact of leverage.

3.0 STRATEGIES TO DELIVER SOLID PERFORMANCE

3.1 THE CHOICE OF THE INVESTMENT STRATEGY

The choice of a specific investment strategy depends on the attitude to risk of the investor. Specifically:

- Long-term and generally risk-averse investors may wish to choose adopt a defensive high-quality, core/core+ position, maintaining low leverage, focusing on the larger, low risk, more liquid office markets. While European office yields have largely compressed over the last two years, this strategy can still deliver decent returns, the yield gap is still comparatively attractive, especially from an Asian viewpoint. This strategy should also limit risks in terms of capital preservation, should a correction in capital values happen.

3.2 THE MARKETS OF PREFERENCE

- Our preferred office markets are economies containing large, high-growth, office-using industries such as professional/business services, high-tech and healthcare. These markets are also characterised by high levels of liquidity. Examples include large markets such as Paris, London, the main German cities (such as Munich, Frankfurt and Berlin), Brussels and Stockholm. However, other markets, where fundamentals are recovering and availability in their central areas is in control, are also attractive, as may provide some upside in terms of capital growth. Examples include Madrid, Milan and Dublin.

3.3 THE CHARACTERISTICS OF THE PROPERTY

While, again, different strategies dictate different approaches to investment, we tend to privilege the following characteristics among acquisition opportunities:

- Attractive buildings with high-quality physical characteristics;
- Excellent location factors in supply-constrained markets that (i) provide competitive market positions and (ii) reduce exposure to new development;
- Leading sustainability features, or the opportunity for these features to be modestly integrated into an asset. This not only increases the ability to attract credit tenants and reduces operating expenses, but also addresses the risk of obsolescence. It also caters to some investors' desire for socially conscious investments.

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