THE INVESTMENT CASE
FOR A EUROPEAN CORE OFFICE FUND

BNP Paribas REIM
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In this short note we enhance and further discuss key themes already outlined in a similar research paper published earlier this year. In that note, we debated a few arguments in favour of investing in European core office property. Those same arguments are still relevant today.

First, European real estate markets are sizeable, diverse, transparent and very liquid. Historically, European real estate has always been a source of attractive absolute and risk-adjusted return vis-à-vis stocks and bonds. Last but not least, yields in Europe are generally higher when compared to the equivalent in other geographies, both in absolute terms and when compared to local bond rates. The same considerations apply when the analysis is restricted to the office sector. Indeed, this sector is the largest, both in terms of investable size and investment turnover. Higher risk-adjusted returns for the office sector are attained by the implementation of geographical diversification across different European markets.

Tactical arguments also support the strategic conceptual framework. The economic outlook remains one of growth and falling unemployment, while new supply of office space remains low, which results in falling vacancy rates and positive rental growth. The unwinding of the current accommodative monetary policy will be very gradual, and with sustained tenant demand, we expect office real investment to achieve outperformance through market and asset selection. While yield compression will become less and less important, future performance will increasingly come from the occupier market. Investment volumes in Europe are solid, with Germany leading the pack and strong activity in the periphery as well.

Following the results of the Dutch and French elections, the risk of populism in Europe is somewhat receding, including the prospect of strengthening French-German relations. The prospects of addressing remaining issues in the Italian banking sector are also improving, while a deal over the Greek bailout is seen as coming soon. Finally, Brexit will take some time in negotiations, but is unlikely to be chaotic.

Core office investment offers desirable characteristics to institutional investors. Quite generally, we consider an office to be core when it shares some specific attributes in terms of location, specification and tenancy. Core office assets usually feature:

- A desirable location i.e. an established and/or sizeable office market
- High-specification, in a new or recently refurbished building
- Long-leases to highly-reputable tenants

Core assets tend to perform well in an up-cycle and are relatively defensive in downturns. Great macro-knowledge needs to be combined with granular insight of market fundamentals to fully reap the benefits of a core strategy.

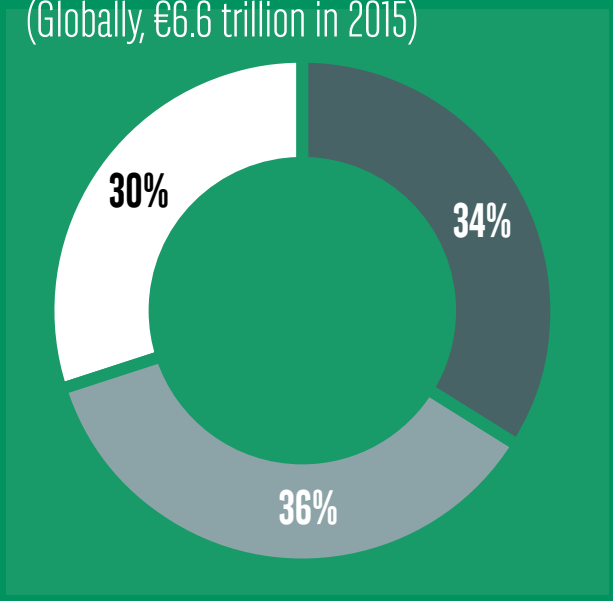
Nowadays, changes in the demand for office space, as a consequence of changing business practices and improving technology, are not accompanied by an equivalent increase in the supply of new office space. As a corollary to the above, there is mounting evidence that new, "green", certified core property outperform older, non-certified buildings.

Country-level strategies no longer have sufficient focus for investors looking for performance. Growth increasingly tends to be concentrated in a number of dynamic cities, which are characterised by features such as, among others, large and/or increasing population, strong and service-oriented diversified economy, good-quality transport and infrastructure, high standards of liveability and some kind of real estate supply constraint. As a real estate investor, we are particularly interested in understanding what, amongst all of the features that make a city successful, are the critical ones for rent and value growth. We have therefore developed a formal, in-house methodology aimed at ranking markets and facilitate the task of making optimal long-term capital allocation decisions. While being more selective results in a lower success rate in competitive auctions, tight investment criteria maximise expected returns and mitigate the chance of loss in capital values in the case of a turn of the market.

WHY EUROPE

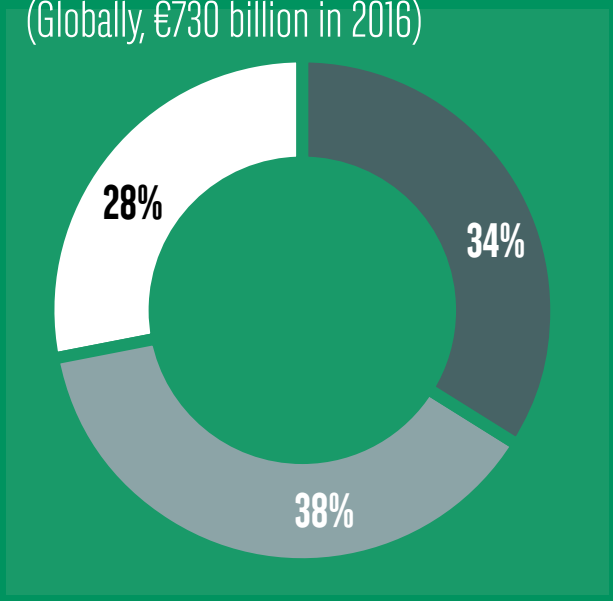
European property markets are sizeable, diverse, transparent and liquid

Size of Institutional Portfolios
(Globally, €6.6 trillion in 2015)



Europe U.S.A. Rest of the world

Investment Volumes 2007-2016
(Globally, €730 billion in 2016)



Source: MSCI, RCAnalytics, BNP Paribas IREIM Research

Market Size and Liquidity

First, European property markets are sizeable and diverse. The total size of European institutional-quality property at end-2015 is estimated by MSCI at around €2.2 trillion, roughly equivalent to the size of the US market. The European market is also very liquid. As a matter of fact, over the last 10 years, European real estate transactions averaged 34% of global turnover[1]. This means that Europe provides a large set of opportunities, both in terms of market and property types.

Europe has around €900 billion of institutional real assets under management, more than the US and around 40% of the global total[2]. Core, low-risk assets represent the largest part of this market.

Transparency

A number of Western European countries rank amongst the most transparent real estate markets[3]. Time series data at micro-location level across sectors and extensive transaction records provide investors with accurate views of the market, while long-term performance can also be easily tracked. These countries also rank high in terms of regulatory and legal protection and governance. As a result, and other things being equal, European real estate markets are amongst the least risky in the world.

Performance

While size and transparency are important, performance is vital. Historically, European real estate has always delivered solid returns, both in absolute and relative terms. The comparison vis-à-vis European bonds and stock is rather eloquent.

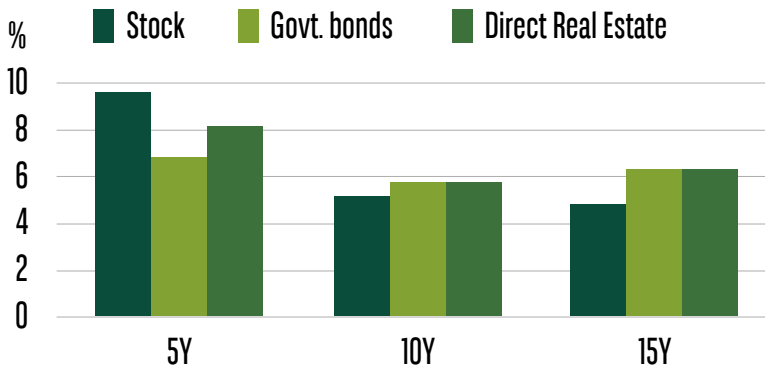
(1) RCA Analytics

(2) Property Fund Research

(3) JLL's Global Real Estate Transparency Index

Yields are higher in Europe when compared to other markets

Historic Returns in Europe



Source: MSCI, STOXX, Macrobond, IBOXX

Risk-Adjusted Returns

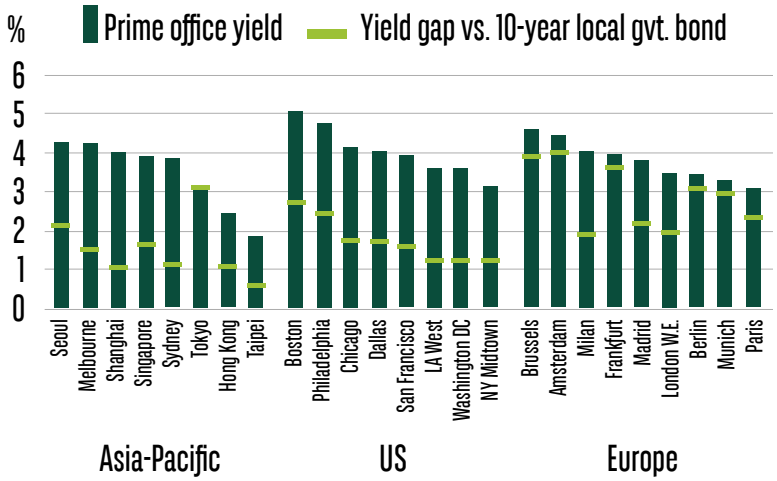
	Stock	Govt. bonds	Direct Real Estate
5Y	0.8	0.8	2.3
10Y	0.3	0.8	0.8
15Y	0.3	1.0	0.9

Source: MSCI, STOXX, Macrobond, IBOXX

Income

In the end, 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 other markets. Moreover, for most markets, risk premia[4] are also higher in Europe.

Prime Office Yield and Gap vs. Bond Yields[4]



Source: PMA, Savills, BNP Paribas IREIM Research. Latest data available

(4) The difference between prime yields and 10-year govt. bonds

WHY CORE OFFICES

Market Size and Liquidity

Office is the largest sector and makes up more than 40% of the institutional-quality European real estate market, according to MSCI. Office assets are also the most transacted type of real estate with 46% of the European total in 2016[5]. As a result, it can be argued that, overall, European offices are relatively liquid from the perspective of the real estate investor.

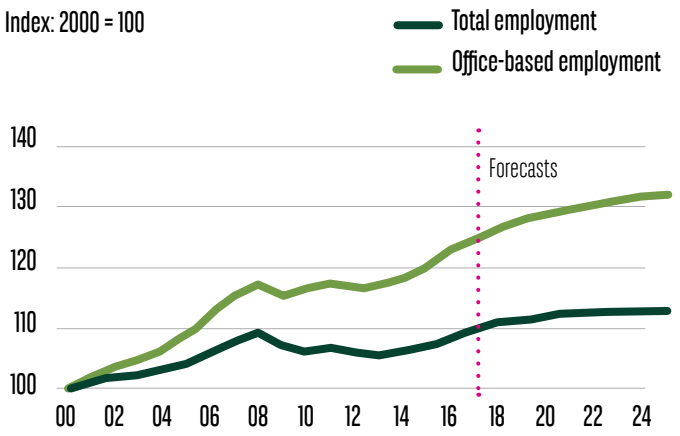
Diversification

Real estate fundamentals and capital markets differ across countries, providing diversification benefits. This shifts out the efficient risk-return frontier for a cross-border portfolio. Moreover, a multi-country portfolio provides diversification across the various markets/sub-markets and economic bases in which the assets are located. Tenants from different industries are also a further source of diversification.

Fundamentals

The European economic recovery has proven to be resilient to adverse shocks, albeit risks exist both at the economic and political level. Most importantly, while overall employment has generally stagnated over the period between the GFC and today, office-based employment has performed well and is expected to continue so, as a result of the outperformance of the business services and the "new-economy"/TMT sectors.

Europe: Total vs. Office-based Employment



Source: Oxford Economics, BNP Paribas IREIM Research

At the same time, development activity in Europe remains low, especially in terms of speculative development. Developers are still cautious, and tend not to start building unless a significant pre-let is secured, while finance for risky developments is still scarce.

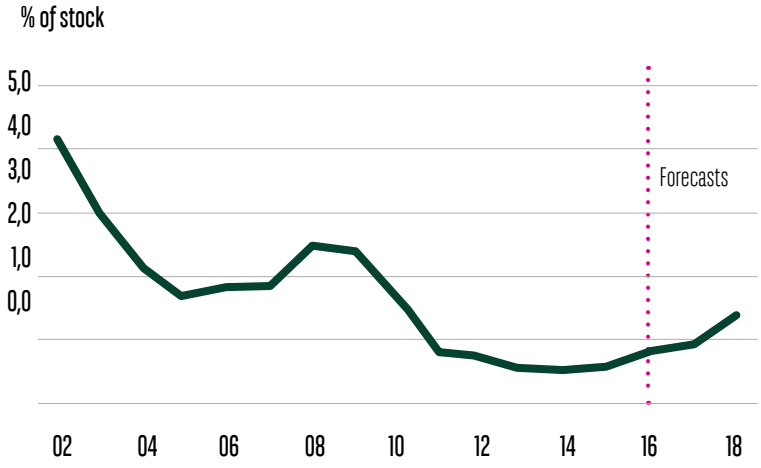
Office return correlations 1990-2016

	Brussels	Paris	Berlin	Frankfurt	Dublin	Milan	Amsterdam	Madrid
Brussels	1.0							
Paris	0.6	1.0						
Berlin	0.7	0.2	1.0					
Frankfurt	0.5	0.6	0.3	1.0				
Dublin	0.4	0.6	0.2	0.4	1.0			
Milan	0.6	0.6	0.2	0.6	0.4	1.0		
Amsterdam	0.6	0.4	0.4	0.5	0.6	0.5	1.0	
Madrid	0.7	0.8	0.3	0.6	0.8	0.7	0.7	1.0

Source: PMA

(5) RCAnalytics (including residential but excluding land transactions)

Europe: Net Office Additions

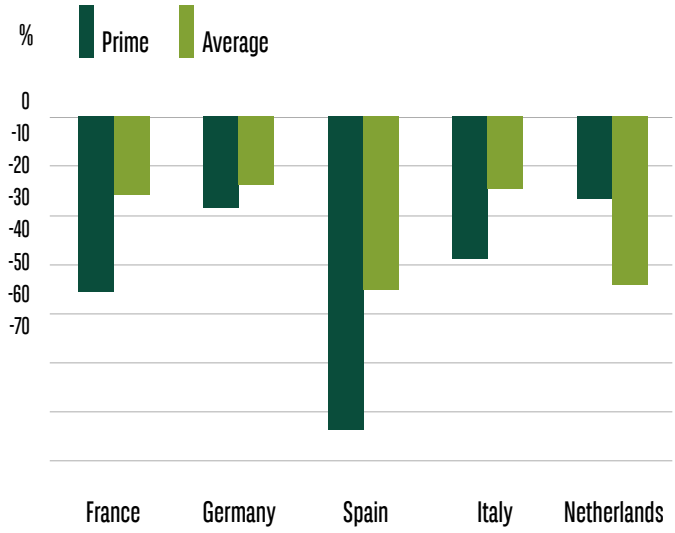


Source: PMA, BNP Paribas IREIM Research. Note. Euro Zone Data

As a result, occupancy levels are also set to improve further, with vacancy rates continuing to fall, which, in turn, support rental values.

Office Capital Values: Prime vs. Average

Peak to trough last cycle*



Source: PMA, BNP Paribas IREIM Research. (*) Peak normally in 2007, trough between 2009 and 2014

Core Offices

Core office investment offers desirable characteristics to institutional investors.

Quite generally, we consider an office to be core when it shares some specific attributes in terms of location, specification and tenancy. Core office assets usually feature:

- A desirable location i.e. an established and/or sizeable office market
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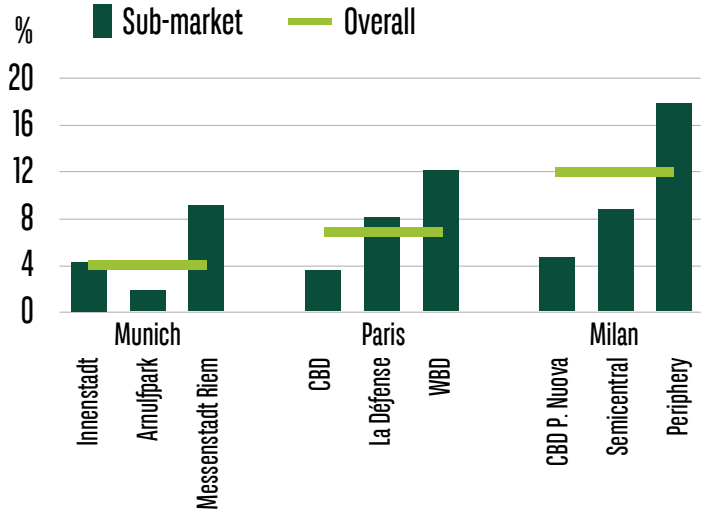
Core assets tend to perform well in an up-cycle and are relatively defensive in downturns. Income remains stable as occupancy stays high and the share of leases rolling over time is low. Prime properties share these characteristics but they feature lower yields, and consequently income, and are more likely to suffer from the compression of the property yield-bond rates gap, this margin being quickly eroded in comparison to non-prime assets. This has the potential to become an issue in the case of a downturn. For example, during the last crisis, prime properties have suffered more than average ones (which include a large component of core and core+ property) in almost all markets.

Geographic disparities remain strong within each city; in general, central and well-connected semi-central, core sub-markets are characterised by limited supply whereas structural vacancy continues to affect negatively peripheral locations in a few markets.

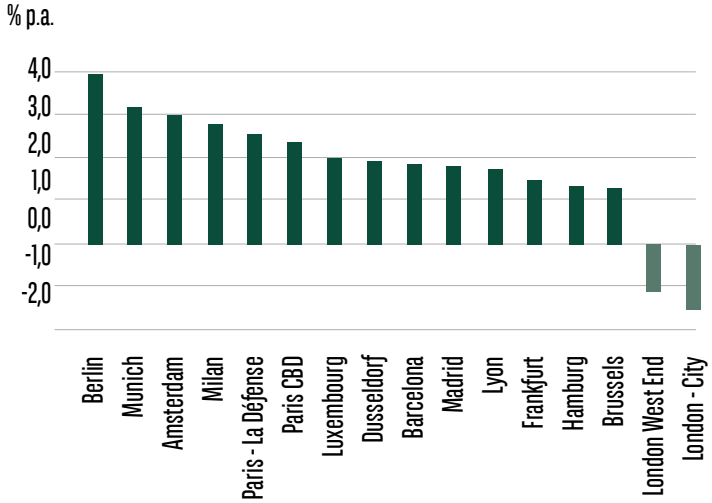
Vacancy by Sub-market



Source: BNP Paribas IREIM Research

The outlook for core real estate net income growth is positive over the next few years, with the notable exception of the UK.

Prime Rental Growth Forecasts 2017-2021



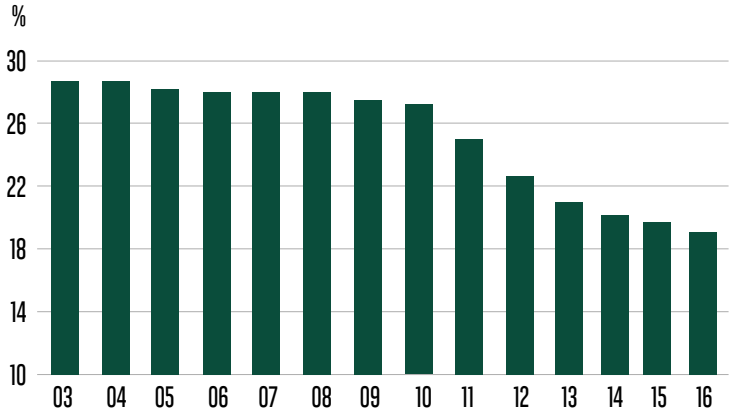
Source: PMA, BNP Paribas IREIM Research

Green and New Properties

The recession produced a moratorium on real estate development across most markets, with new supply falling below the level required to maintain the existing stock, at least in most office destinations. At the same time, technology continues to be the catalyst for change in all areas of business, and office real estate is no exception. Demand for office space is changing, as a consequence of both changing business practices and the aforementioned adoption of new technologies. The shape of the future office will be different from the past, with an increasing component for common, shared space and amenities. For example, take-up of serviced offices in newly occupied space in London has been around 8% over the last five years. Anecdotal evidence shows that the importance of serviced offices and new operators is increasing in other European countries. As a result, the demand for new, flexible premises, which are currently scarce in supply, will increase.

(6) Currently, the world's largest market for serviced offices and operators

European Office Stock less than 10 years Old*

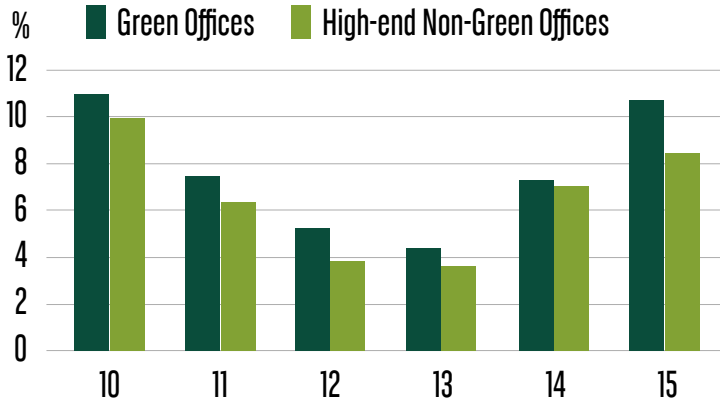


Source: PMA, BNP Paribas IREIM Research. (*) European data

Investors and businesses are gradually incorporating information on environmental and social performance into their investment and occupational underwriting decisions. The property sector is of clear interest to policymakers given that construction and work-related activities account for an estimated 40% of annual energy consumption and up to 30% of all energy-related greenhouse gas emissions across the globe. Although the stock of energy-certified buildings available remains relatively small in most real estate markets, the sector has seen rapid growth in recent years and this trend is expected to continue.

In general, green buildings are expected to be rented more quickly and to carry lower rental incentives. Overall, running costs should also be lower for a green building. Even more important is that evidence is increasingly supporting the hypothesis that green properties have generally commanded higher returns compared to non-certified buildings.

Total Returns - French Offices



Source: MSCI

WHICH MARKETS

Successful Cities

Country-level strategies no longer have sufficient focus for investor looking for performance. As a real estate investor, we are particularly interested in understanding what, amongst all of the features that make a city successful, are the critical ones for real estate rent and value growth. We have therefore developed a formal, in-house, methodology aimed at ranking markets and facilitate the task of making optimal long term-capital allocation decisions. While being more selective result in a lower success rate in competitive auctions, tight investment criteria maximise expected returns and mitigate the chance of loss in capital values in the case of a turn of the market.

A successful city will generally have most, if not all, of the following features:

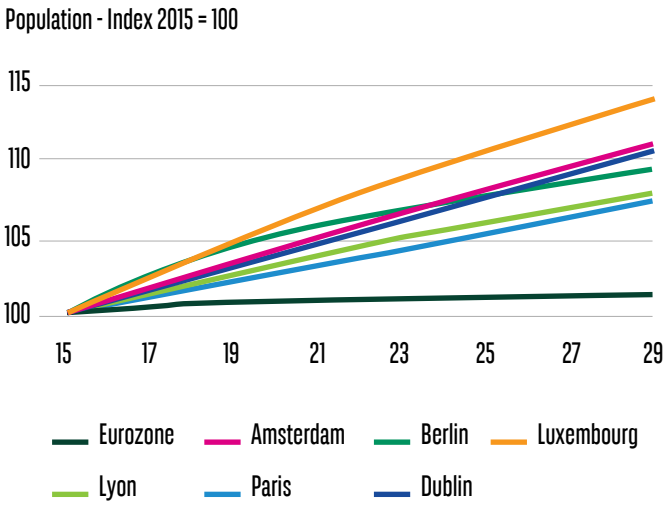
- Large and/or rapidly increasing population and GDP;
- A strong and diversified economy including advanced business services;
- A well-educated workforce;
- A good transport and general infrastructure system;
- Good entertainment and cultural offer;
- A general sense of vibrancy and innovation;
- High standard of liveability;
- A positive brand and good reputation;
- A responsible environmental policy;
- Some kind of real estate supply constraints

Core funds which focus on these structural features will generate superior income growth over multiple cycles. This long-term investment perspective is especially attractive as yields are historically low and. income quality becomes more important.

For example, while population in the euro zone as a whole is stagnating, the cities that are benefitting from increasing urbanisation and stronger employment growth are attracting both domestic and foreign migration, which, in turn, is expected to have a positive effect on real estate fundamentals. Those same cities also tend to outperform their respective national markets, in terms of total returns.

Population in Selected European Cities

We tend to rank and select cities on the basis of a combination of a few criteria, including population, office stock, take-up activity, investment volumes. GDP growth and industry diversification. Other "soft" factors, including some of the features outlined above, are also taken into account.



Source: Oxford Economics

Ranking Cities

Based on our methodology we have selected more than 30 investable European office markets[7]. We have created three groups of investable markets, with the tier 1 group including the main markets in the core countries of Germany and France, the tier 2 group including all other economic/political capitals within the euro zone and the tier 3 including secondary cities in Germany and France. Tier 1 markets will receive the largest portfolio allocation, while the allocation for tier 3 markets will be small and subject to opportunities becoming available. The list of cities outlined below is only indicative, other markets can be selected if they fit our investment criteria.

Expertise and Ground Knowledge

Core, multi-country funds primarily invest in stabilised assets and, occasionally, can take some letting risk in low-vacancy sub-markets where they can easily let available space. This strategy captures diversification benefits that reduce overall portfolio risk and generate higher returns.

Specialised property type expertise is required, through the use of in-house, on-the-ground professionals. This is a key benefit to investing through a core fund. The greater scale of a core open end fund also enables them to invest in larger assets than a typical separate account.

Tier 1 cities	Tier 2 cities	Tier 3 cities
Berlin	Amsterdam	Bonn
Cologne	Barcelona	Bordeaux
Dusseldorf	Brussels	Essen
Frankfurt	Dublin	Hannover
Hamburg	Helsinki	Leipzig
Lyon	Lisbon	Lille
Munich	Luxembourg	Marseille
Paris region	Madrid	Nantes
Stuttgart	Milan	Rotterdam
	Rome	The Hague
	Vienna	Toulouse

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(7) The strategy focuses on the euro zone. While the UK is the largest European market, it is also very advanced in the cycle. Moreover, we feel that this market will go through some value correction due to the effects of Brexit.