DO PROPERTY CYCLES STILL MATTER?

Pol Robert Tansens

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BNP PARIBAS
WEALTH MANAGEMENT

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SUMMARY

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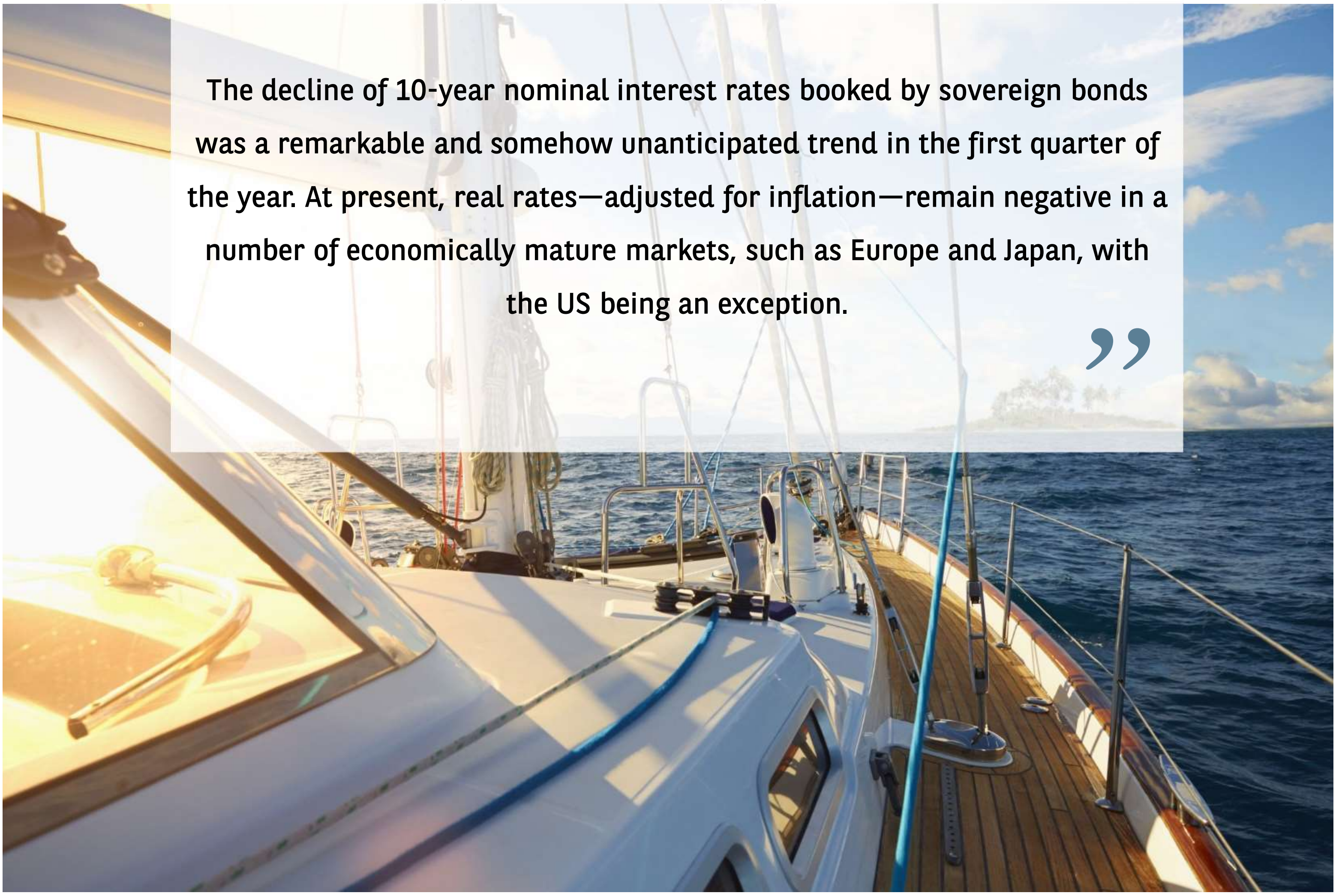
These are fascinating times for property investors, with real estate and macro-economic factors coming into play.

Increasingly today capital markets are channelling financial capital flows to and within underlying physical assets, and hence they determine opportunity costs and property values.



The decline of 10-year nominal interest rates booked by sovereign bonds was a remarkable and somehow unanticipated trend in the first quarter of the year. At present, real rates—adjusted for inflation—remain negative in a number of economically mature markets, such as Europe and Japan, with the US being an exception.

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SUMMARY

The German 10-year government bond yield temporarily fell to -8 basis points at the end of March on fears of weaker economic growth re-emerging in Europe (source: TradingEconomics, 27 March 2019). So, growth worries are back, and obviously, the Brexit saga is not helping things along.

This fall came after the US Federal Reserve Bank (Fed) changed its monetary stance at its March meeting, by reducing interest rate projections from 2 to 0 hikes this year, with Fed Chairman Jerome Powell justifying his cautious position by the global economy's headwinds. In fact, fears of a slowing economy started to dominate inflation concerns. The Fed's fund rate is expected to remain unchanged at 2.50% for the rest of this year. US sovereign bonds also reflected

North America's maturing economic growth cycle, with the spread between the 10-year and 3-month Treasury Notes falling briefly below zero on 25 March. This led to an inverted yield curve for the first time since 2007 (source: TradingEconomics). However, at the end of April, bond yields inched up again, driven by reasonable economic growth projections for China. In April, BNP Paribas Wealth Management lowered its 12-month targets for 10-year sovereign bond yields to 2.70% for the 30-year US Treasury Note, and to 0.30% for the 10-year German Bund.

Chart 1:
Ten-year real sovereign bond yields since 2004

Source: Thomson Reuters Datastream, 16/04/2019

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Whether or not fears of weaker economic growth are justified, and whether the European growth scenario is increasingly flirting with Japan's scenario, this does not matter to property investors. Today, there are different degrees of uncertainty in the investment market. For example, what will be the outcome of the ongoing trade negotiations between the three biggest economies of the world (US-China, US-Europe)? And how will the endless Brexit saga unfold?

Of more relevance to property investors is global real interest rates. We assume the latter will remain reasonably low or outright negative for quite some time irrespective of economic trends, but we do not exclude a modest increase in the coming months. Low real interest rates are very supportive for real-estate investors, with gross initial property yields (capitalization rates) usually exceeding the meagre cash returns generated by other asset classes. Plausibly, internal rates of return (IRRs) are magnified by the advantageous cost of borrowing when purchasing property. Investors will continue to compare the expected real-estate returns implied by current capitalization rates with nominal (and real) long-term Investment Grade bond yields.

Listed Real Estate Investment Trusts (REITs) are in a good position to demonstrate the correlation between interest rates and returns (although the correlation is usually short-lived). The majority of returns (share price evolution + dividends), generated by REITs, ended in negative territory last year.

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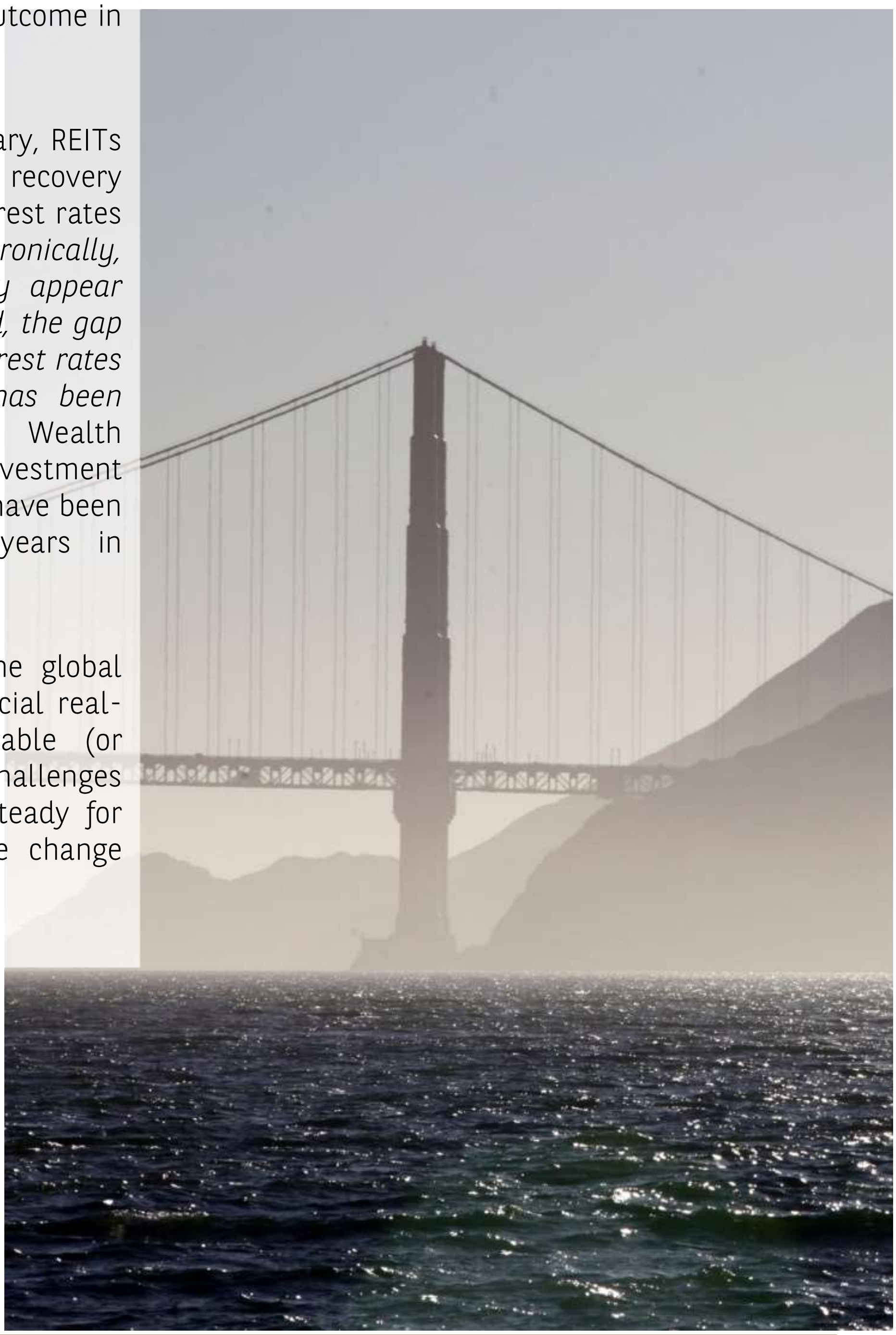
Continental Europe saw a bad performance, with losses of up to 16% in France for instance (though the disparity in total returns between European countries was staggering, for example France vs. Belgium and Germany). Incidentally, the modest increase in nominal interest rates definitely had some influence on this outcome in 2018.

What a difference this year! Since January, REITs have been experiencing a spectacular recovery overall, mainly in anticipation that interest rates will remain low for quite some time. "*Ironically, fears of a slowdown in the economy appear positive for REITs at first glance. Indeed, the gap between 10-year risk-free nominal interest rates and average gross dividend yields has been widening*." (source: BNP Paribas Wealth Management, Real Estate Securities Investment Guide, April 2019). What's more, REITs have been outperforming common shares for years in Europe, the US and Asia.

Meanwhile, what has happened in the global occupier markets? Worldwide, commercial real-estate markets enjoyed another stable (or strong) year in 2018, despite ongoing challenges in the retail sector. Yet, data were steady for other commercial markets, with little change from a year ago.



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The logistics sector continued to be bolstered by a shift to online sales whereas many office markets posted attractive returns (regardless of geography). Remarkably, in the US, returns from retail activities mildly rebounded during the fourth quarter of 2018. Furthermore, global housing markets either remained resilient in most parts of the world despite price disparities observed in specific countries (US, France, Germany) while some country/regional markets continued to recover (Southern Europe, Singapore). However, house prices started falling in 'overvalued' markets such as Australia, Canada, Switzerland and, amazingly, Hong Kong.

The risk premiums 'required' by real-estate investors are currently quite low. In some gateway cities, they may be uncomfortably low, although the gap between risk-free rates and rental yields is still at least 200 basis points. Indeed, monetary policy—as described above—remains flattering to property investors, allowing them to continue to allocate funds to real estate. We do not expect this to change soon.

So what do we expect for this year? Although we refuse to speak of a 'disconnection' between capital markets (driven by an abundant supply of capital) and the space markets (occupier markets), we believe that property yields (capitalization rates) cannot decline indefinitely at a time when rental growth is modest or flat.

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The logistics sector is an exception to the rule, as is a number of specific prime office markets, like Berlin and Singapore. Investors should factor in slowing capital growth rates and start focusing on recurring rental income, irrespective of geography.

To cite but one example, even though the European prime office markets are fully priced, this segment is expected to deliver a 4% unlevered total return on average in 2019. Gross initial yields (GIYs), carried by offices, may slightly expand by roughly 50 basis points (bps) while the increase in yields should be even more modest for logistics assets. We examine European office markets in more detail in our report, using as a basis BNP Paribas Real Estate's capital performance projections.

Do property cycles matter less nowadays? In a nutshell, yes. We believe they are still relevant, but perhaps a little less than before. Even though investors try to avoid buying near the peak of property cycles, it is not the end of the world if they do. Probably the most important cause of investors being forced to sell in a downturn is the use of (too much) debt, as seen during the previous credit crisis of 2007-2009. But investors with acceptable loan-to-value (LTV) ratios can usually ride out any downswings, even prolonged.

CONCLUSION

As such, our real-estate investment strategy is consistent and unchanged, with a particular recommendation for the 'value-added' property segment, especially in Europe (including the United Kingdom). Nonetheless, real-estate investments in top-tiered locations remain attractive, even though trophy bricks are quite pricey as we are nearing the last stage of the property cycle in some areas. The focus should therefore be on the net rental yield, i.e. on the tenant, and less on capital appreciation return prospects.

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THE WORLD'S COMMERCIAL REAL-ESTATE MARKETS

WILL THE CURRENT PROPERTY CYCLES IN EUROPE CONTINUE?

The positive momentum for commercial real-estate investments in Europe continued in 2018, with an investment volume of EUR 264bn in 2018 for all commercial property segments combined, only 2% below 2017, which was a record year.

"*On the back of a stable occupier market, European commercial real estate enters 2019 with some of the strongest fundamentals ever seen on the continent.*" (source: BNP Paribas Real Estate, At a glance: European Property Prospects – February 2019).

According to BNP Paribas Real Estate, gross initial prime yields (GIYs) in some core markets stand at a historically low level, so there is little room for further compression, bar the logistics sector.

Let's take the European office market as an example. "*For 70% of the office markets that we cover in our report, prime yields will remain stable in 2019. We do see potential for property yields to start unwinding from mid-2020 coinciding with resurgence in core inflation and thus monetary policy tightening. Even so we think the increase will be gradual, with the cumulative average rise in yields over the 5-year forecast period expected to be +50bps for offices and +35bps for logistics.*" (source: At a glance: European Property Prospects – February 2019).

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Forecasts for office rental growth in Europe range from virtually non-existent, to around 8% this year. Berlin is expected to enjoy the strongest growth in office rents of 8%. Even though Spanish cities have already experienced sharp growth, they still have some potential with expected average annual growth exceeding 2% over 5 years. French office markets are projected to generate stable or slightly higher rents, while London's could decline initially due to Brexit.

As we wrote in our previous property report published in October 2018, capital appreciation returns are set to slow further. Values of tier-1 offices cannot go up much higher, because GIYs would be ridiculously tight. As a result, total returns booked by first-grade offices—after adding net rental income—are expected to be in the single digits for most office markets in 2019. One exception is Berlin (+11%), a market supported by an expected growth in rents, despite carrying the lowest real-estate yield in Europe (2.7%).

Prime total returns across the 36 European markets that BNP Paribas Real Estate covers may average +4% in 2019. The best returns are expected in Madrid (+8%), Amsterdam (+9%) and the German cities of Cologne (+9%), Dusseldorf (+8%) and Frankfurt (+7.5%).

"*In contrast to the prime segment, the broader market (including secondary assets) will have a higher level of return. The total return here will average +6.75% in 2019. There are only three markets: Berlin (+16%), Marseille (+11%) and Amsterdam (+10%) with double-digit returns. A large part of this is due to the higher yield, providing a higher income return relative to the prime segment. In the case of Berlin, again the expected strong rental upswing is supporting higher capital growth*." (source: BNP Paribas Real Estate, February 2019).

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Table 1: Total return projections for European office markets (prime and secondary assets combined)

Total return for Offices		2019	2020
Belgium	Brussels	6.91	6.83
Czech Republic	Prague	5.70	0.97
Denmark	Copenhagen	4.03	4.02
Finland	Helsinki	2.53	2.90
France	Greater Paris	4,96	4.05
France	Central Paris	4.76	4.43
France	La Défense	1.98	1.54
France	Paris CBD	5.56	4.18
France	Lille	9.77	6.35
France	Lyon	6.85	5.72
France	Marseille	10.87	5.78
Germany	Berlin	15.92	10.28
Germany	Cologne	9.48	8.00
Germany	Düsseldorf	7.57	6.94
Germany	Frankfurt	9.10	6.05
Germany	Hamburg	7.91	5.52
Germany	Munich	8.98	5.19
Germany	Stuttgart	7.09	4.96
Hungary	Budapest	7.82	6.33
Italy	Milan	5.61	6.16
Italy	Rome	5.54	6.52
Ireland	Dublin	5.10	-0.28
Netherlands	Amsterdam	10.15	8.14
Poland	Warsaw	3.50	3.25
Portugal	Lisbon	9.87	8.00
Norway	Oslo	4.50	5.19
Spain	Barcelona	9.39	7.79
Spain	Madrid	8.89	6.45
Sweden	Stockholm	6.84	6.26
United Kingdom	Central London	0.82	-1.59
United Kingdom	City	0.67	-1.28
United Kingdom	West End	-0.27	-1.25
United Kingdom	Birmingham	2.67	2.49

Source: BNP Paribas Real Estate, European Office Market Forecast, February 2019

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How did European debt pricing look at the end of 2018? Senior debt contracted in first-class European offices and the loan-to-value ratio (LTV) was below 65% in many markets. Borrowing costs for commercial real estate generally decreased in 2018, due to lower swap rates and margins. "*From the lenders' point of view, risk undoubtedly increased in 2018; yields decreased, underlying values increased and key risk measures appear to be tight in some markets, with costs generally below 2.5% and very often below 1.5% all-inclusive.*" (source: CBRE, European debt, 2018 in review, Outlook for 2019, March 2019). For borrowers, lower debt costs mean that there are many markets which offer them the required IRRs.

TAX CHANGES TO NON-RESIDENT INVESTORS IN COMMERCIAL PROPERTY IN THE UK

In 2015, the government introduced the 'non-resident capital gains tax' (NRCGT), which applied to all individuals, trusts and companies having non-residency status. However, at the time, commercial properties were not affected by the NRCGT. As a consequence, non-residents did not pay any tax on UK commercial property (retail, offices, hotels, etc.) whether they owned the property directly or through a company between 2015 and 6 April 2019 (the start of the new tax year).

The NRCGT exemption on commercial property held by non-UK residents was, in certain cases, removed on 6 April 2019. Consequently, certain foreign companies, private individuals, overseas trusts and Jersey Property Unit Trusts are now liable to pay NRCGT on the taxable gain made from selling commercial property. Where applicable, the NRCGT will be applied to any taxable gain realized between the future disposal point and the new base date of 6 April 2019 (source: BNP Paribas Real Estate, April 2019).

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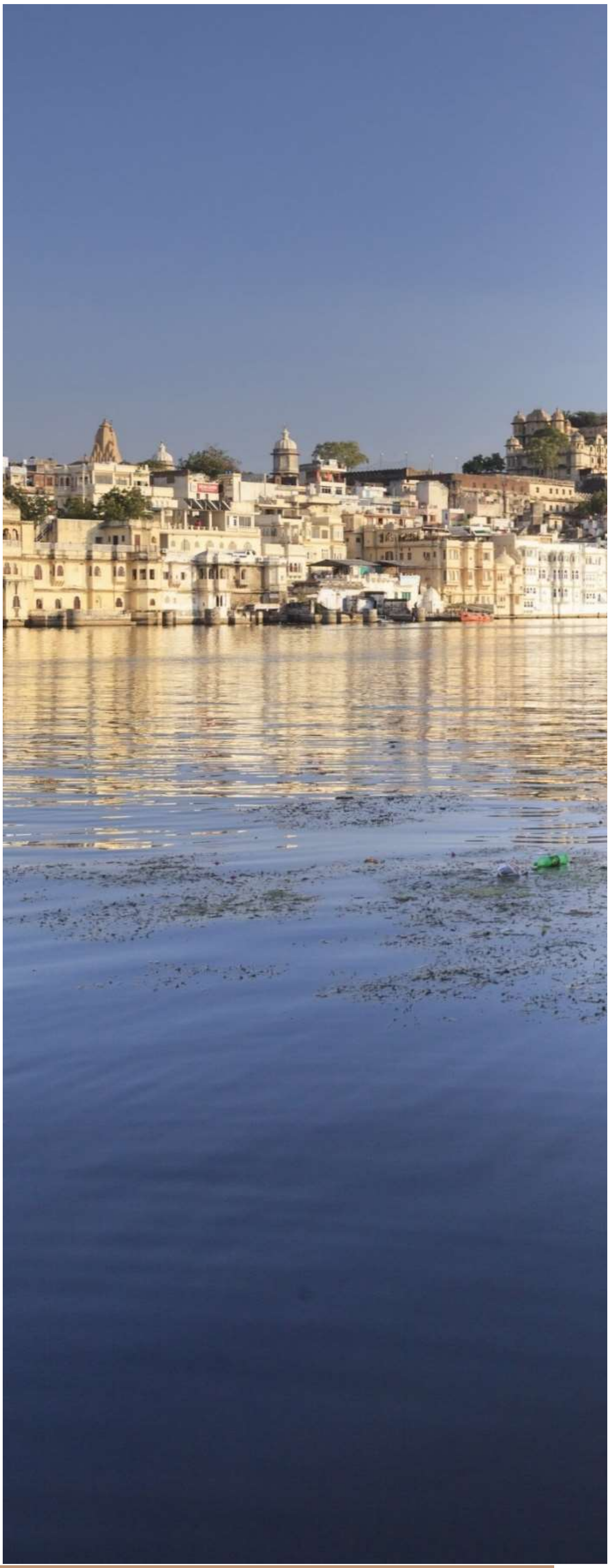
RETAIL UNDER PRESSURE BUT NOT CATASTROPHIC

The retail segment is still under pressure. However, the newly-coined term, 'disruption', may not be appropriate to describe in detail what is happening in Europe (and indeed in other parts of the world).

Online sales do not necessarily pose a threat to the existence of physical stores. In fact, they can support them when retailers adopt a so-called ‘omni-channel’ approach. Retailers in Europe have developed a unified supply chain, where physical and online stores use the same distribution systems (with 'click and collect').

E-commerce and logistics companies will continue to play a leading role in the industrial real-estate industry, with 'last mile delivery' becoming increasingly important. ‘Last mile’ is a term used in supply chain management and transportation planning to describe the movement of people and goods from a transportation hub to a final destination in the home.



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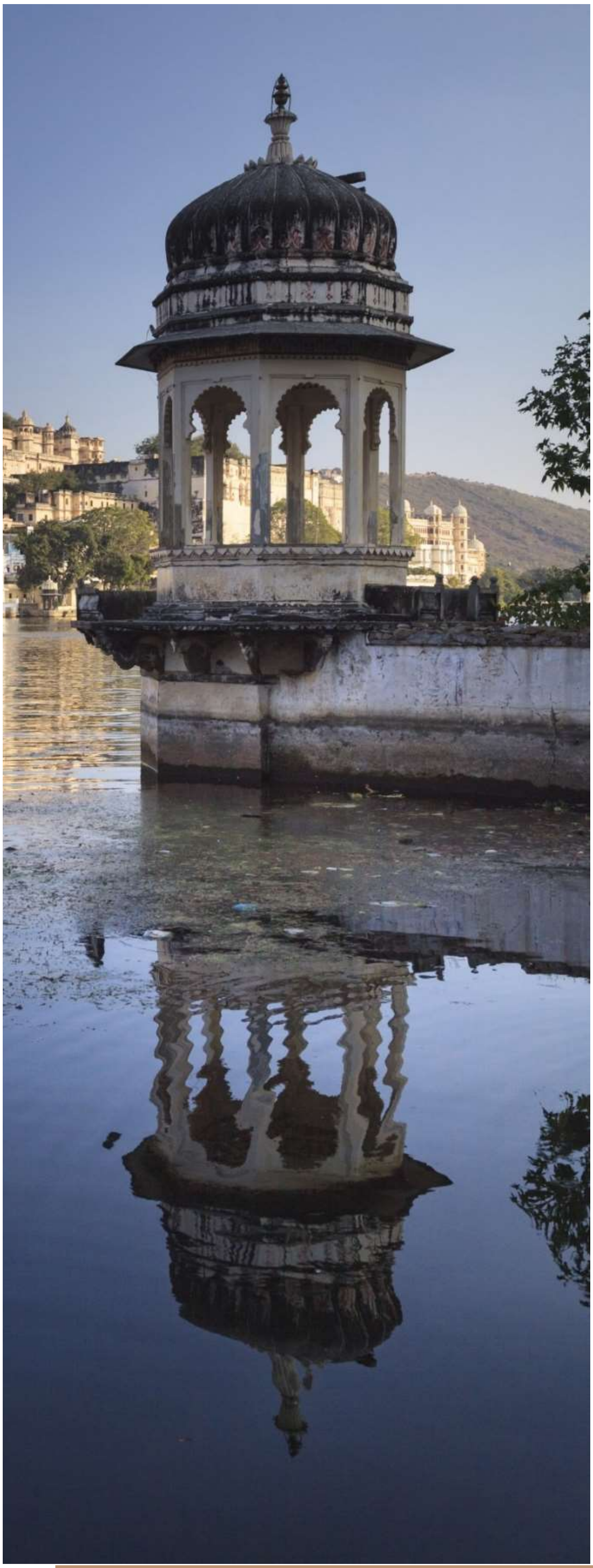

EXPECTATIONS OF THE RICS: FOCUS ON SOUTHERN EUROPE AND GERMANY

Respondents to the Royal Institution of Chartered Surveyors (RICS) Global Commercial Property Monitor rated the majority of global real-estate markets as fairly stable in the fourth quarter of 2018, despite higher macro-economic risks (RICS, 25 February 2019). Europe continues to deliver the best results in absolute terms, both in terms of investor and occupier markets, with Greece, Hungary, Portugal and Spain ranking as the best-performing European countries. The Netherlands and Germany continue to generate considerable interest, although the latter is considered to be closer to the top of the cycle and generally tighter from a valuation point of view.

The picture is rather bleak in the retail sector. *"Changes in consumer behaviour and the shift to online sales, in particular, have a negative impact on retail occupants (margins under pressure), with vacancy rates increasing across the sector in Europe as a whole. In France, the retail sector, particularly in secondary locations, is also facing more difficult conditions. Indeed, investor demand remains in decline, due to the deterioration in occupants' fundamentals and the resulting increase in vacancy rates*." (source: RICS Global Commercial Property Monitor, 26 February 2019).

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WHAT ARE THE TRENDS IN US COMMERCIAL REAL ESTATE MARKETS?

The National Council of Real Estate Investment Fiduciaries (NCREIF) has published the first quarter 2019 (1Q19) results for the NCREIF Property Index (NPI). The NPI's quarterly total return—generated by a combination of offices, retail, industry, hotels and apartments—was very good in the first quarter. The total return was 1.80% in 1Q19, up from 1.38% in the previous quarter, and consisted of an income return of 1.11% and a capital return of 0.69%. This is an unlevered return for mostly 'core' real estate held by institutional investors across the United States (source: NCREIF, 25 April 2019).

Industrial properties, which are primarily warehouses, remained the best-performing property asset class, with a return of 3.02% for the quarter although down from the prior quarter's return of 3.40%. Office activities took the second spot with a return of 1.63% that was just slightly less than its 1.65% return in 4Q18. Returns from Apartment activities were unchanged at 1.35% while total returns from the hotel business dropped from 1.21% to 0.44%. Remarkably, returns from Retail rebounded during the quarter from a negative 0.43% in 4Q18 to a positive 1.74%.

ASIA: SLOWING CAPITAL APPRECIATION RETURNS FOR OFFICES

In 2018, the performance of the office leasing markets remained solid, with full-year 2018 volumes up by 21% over 2017. Flexible office space was one of the main drivers of rental activity. Seoul experienced the largest improvement in quarterly rental volumes, while Tokyo's 4Q18 volumes declined significantly due to low vacancy rates and limited pre-leasing options. So, there may be opportunities among developers in the Tokyo office market, where demand is strong for new buildings. Similarly, Melbourne and Sydney also experienced thin leasing activity due to a lack of prime products. Shanghai's quarterly volumes increased slightly because of occupational demand from foreign financial institutions. Hong Kong's quarterly rental volumes edged up year-on-year, supported by flexible space operators (source: The Office Index, Jones Lang LaSalle, 4Q18).

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Office rents in Asia Pacific remained steady, although they grew at a slower rate of 1% quarter-on-quarter in 4Q18 (vs. 1.2% in the previous quarter). Rents in Hong Kong Central continued to slow due to weaker demand from financial companies in Mainland China. In addition, quarterly rental growth in Shanghai's Central Business District decelerated as well because of a significant amount of new supply in Pudong. In Seoul, quarterly office rents declined slightly in 4Q18. However, office rents in Singapore continued to climb during the quarter (source: The Office Index, Jones Lang LaSalle, 4Q18).

Hong Kong is seeing sustained demand for investment opportunities in self-storage. By definition, a self-storage facility is usually divided into small units (some of them may be climate-controlled), and are also called mini-storage facilities or mini-warehouses. Warehousing storage and services are often provided to multiple customers.

Undoubtedly, Hong Kong commands the highest residential prices in the world, with the average resident living in only 160 square feet ($15m^2$). Hong Kong was already undersupplied in self-storage rental units due to a terrible fire in June 2016 that resulted in the closure of more than 100 facilities, representing approximately 25% of 'the self-storage market' (source: Infrared NF Hong Kong, March 2019). Actually, self-storage facilities could be considered as a way for residents to extend 'residential space'.

CONCLUSION

We favour offices and logistics over retail investments—for the time being—regardless of geography. It is clear that we are in the 'late' property cycle in many markets, though we believe that investors will not get stuck at the losing end of cyclical swings in the property market. Capital markets remain very supportive indeed. However, investors should take out moderate levels of debt to avoid a 'fire' (i.e. forced) sale at the end of a market downturn. Caution is needed for lower-tiered markets. It is better to invest in properties that can be repositioned in prime locations. Investors cannot afford to ignore lower capital appreciation returns in the coming months.

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THE WORLD'S HOUSING MARKETS

THE STRONGEST CLIMB IN REAL HOUSE PRICES WAS IN … MALTA

Most of Europe and parts of Asia continued to experience strong annual increases in real prices in the fourth quarter of last year, with Malta and Manila (Makati district) in pole positions. Undoubtedly, the small island remains the strongest housing market according to the Global Property Guide's global survey. Annual house prices jumped by 11.57% in 4Q18, after annual increases of 12.86% in 3Q18. Malta attracts owner-occupiers, and is less of a place for tenants, so foreign investors' demand for residential real estate is very high.

There have also been significant increases in the Netherlands, which has fully recovered from the housing slump a couple of years ago. In addition, Singapore, Chile, Germany, Ireland and Portugal also recorded markedly higher prices in real terms in 2018.

On the other hand, some residential markets, which are generally very expensive, experienced a fall in house prices in the same period. This was evident in Switzerland, Beijing and, surprisingly, Hong Kong. The latter city recorded a quarterly loss of about 9% in real terms in 4Q18, wiping out all previous gains for the year.

The largest annual falls in house prices were observed in Egypt (-19.24%), Turkey (-8.82%), Dubai (once again, 8.22%), Kiev (-6.09%) and, as already indicated, Beijing (-3.73%).

Table 2: Real house prices as at 31 December 2018

Ranking	Country	y-o-y (%)		q-o-q (%)
		4Q17	4Q18	4Q18
1	Malta	7.39	10.48	5.70
2	Manila (Makati)	7.34	9.91	5.55
3	Netherlands	6.92	8.49	2.14
4	Singapore	0.79	7.32	0.03
5	Chile	6.69	6.94	1.88
6	Germany	4.45	6.78	1.39
7	Ireland	11.68	5.81	0.69
8	Portugal	3.03	5.39	2.03
…	…	…	…	…
33	Hong Kong	12.78	-0.92	-8.73
…	…	…	…	…
37	Qatar	-10.42	-2.24	-0.22
38	Switzerland	-1.70	-2.56	-0,23
39	Israel	2.19	-3.25	-0.78
40	Macedonia	0.78	-3.51	-1.52
41	Sweden	5.70	-3.55	-0.19
42	China (Beijing)	-3.32	-3.73	-1.00
43	Ukraine (Kiev)	-7.97	-6.09	-1.45
44	Dubai	-5.23	-8.22	-1.98
45	Turkey	-0.71	-8.82	0.91
46	Egypt	-11.49	-19.24	-16.84

Source: Global Property Guide, March 2019. Home prices adjusted for inflation

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HONG KONG HAS LOST ITS STELLAR PERFORMER STATUS

Annual performance ended in the red in 4Q18. More importantly, house prices plummeted by 8.73% in the fourth quarter, reflecting deteriorating market conditions. This was a new phenomenon because home prices in Hong Kong had been achieving astonishing levels for years. That said, the latest news from the Hong Kong residential market is somewhat mixed. In February 2019, monthly home sales slid by 10% month-on-month due to a dearth of launches in the primary market.

Yet, capital values for the mass market stabilized during the month, edging up by 0.4% after dipping by 1.1% m-o-m in January. This is the first monthly rise since prices peaked at the end of August 2018 (source: Jones Lang LaSalle, Property market Monitor, March 2019).

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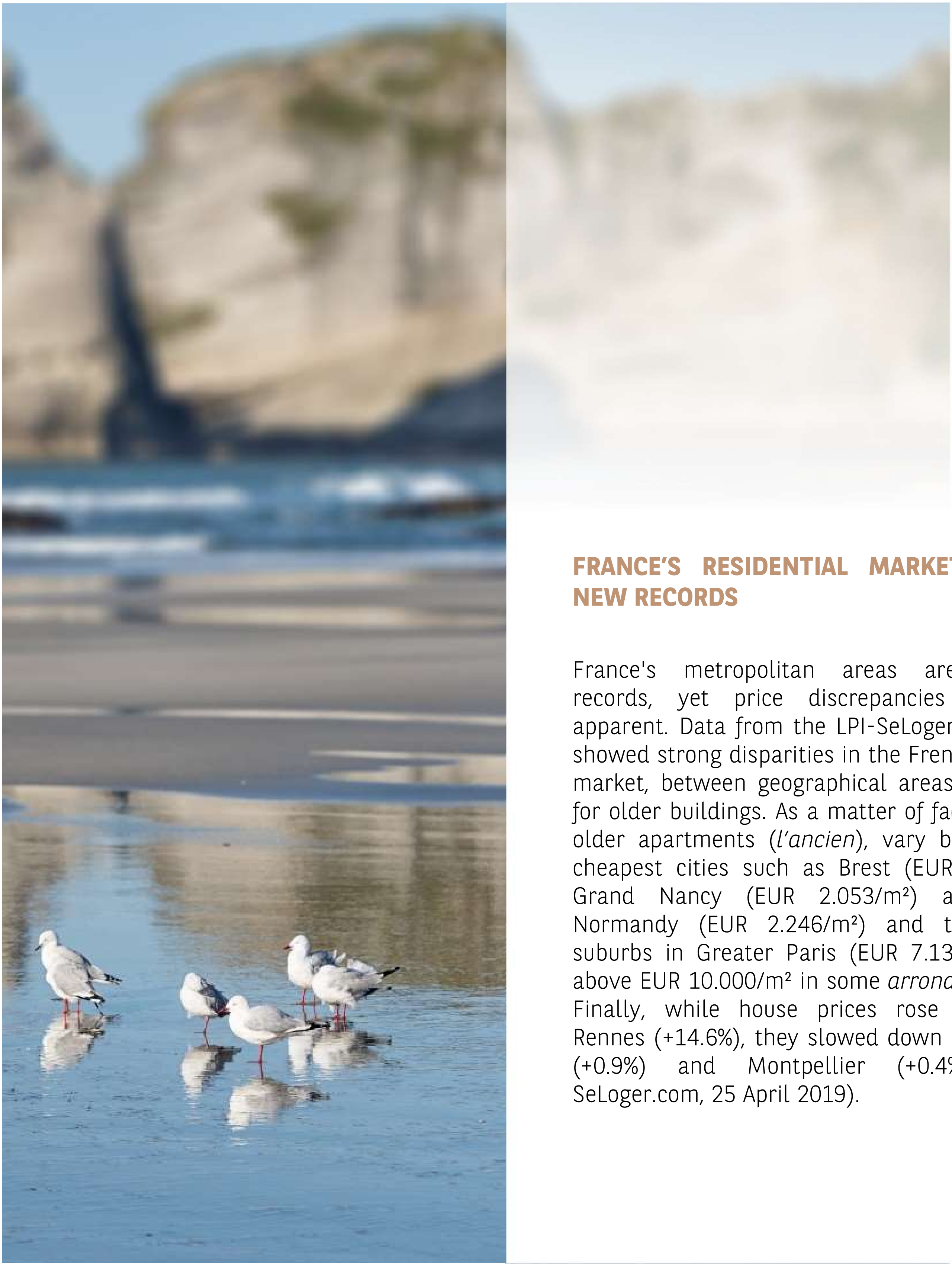

FRANCE’S RESIDENTIAL MARKET BREAKS NEW RECORDS

France's metropolitan areas are breaking records, yet price discrepancies are very apparent. Data from the LPI-SeLoger barometer showed strong disparities in the French property market, between geographical areas, especially for older buildings. As a matter of fact, prices of older apartments (*l’ancien*), vary between the cheapest cities such as Brest (EUR 1,902/m²), Grand Nancy (EUR 2.053/m²) and Rouen, Normandy (EUR 2.246/m²) and the highest suburbs in Greater Paris (EUR 7.137/m², often above EUR 10.000/m² in some *arrondissements*). Finally, while house prices rose sharply in Rennes (+14.6%), they slowed down in Grenoble (+0.9%) and Montpellier (+0.4%, source: SeLoger.com, 25 April 2019).

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SUBSTANTIAL REGIONAL PRICE DISPARITY ACROSS THE UK

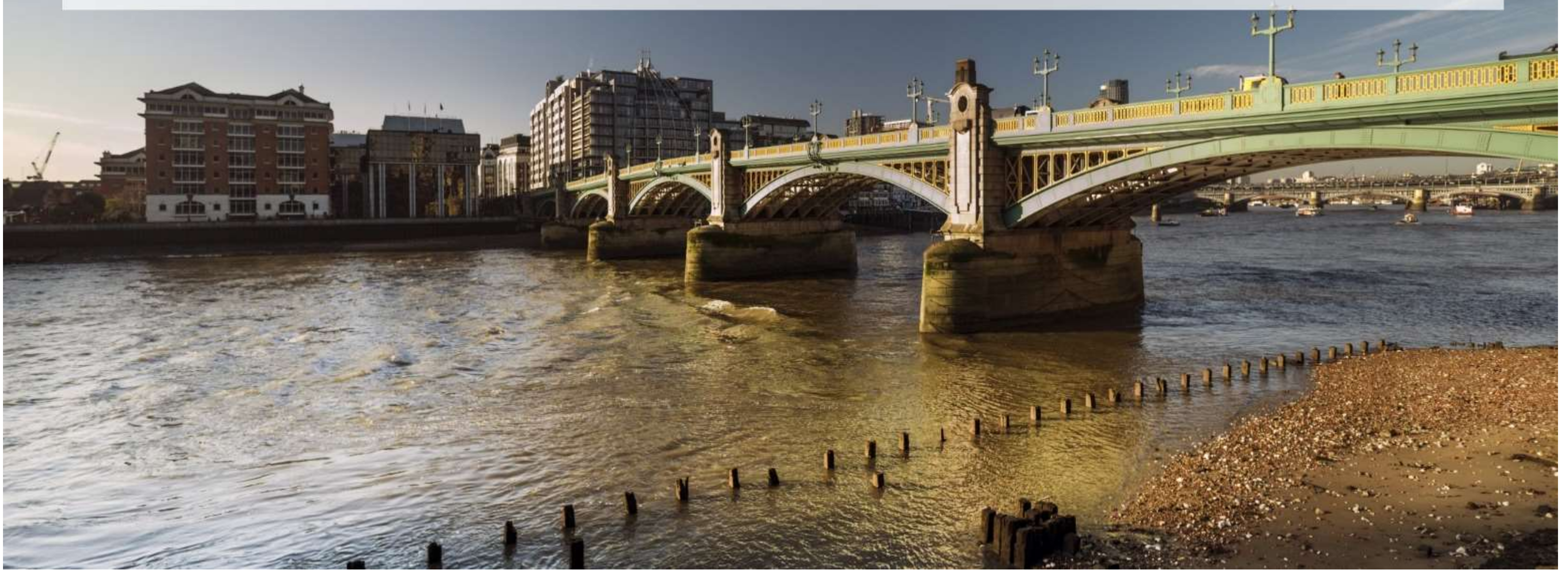
Asking prices for homes in the United Kingdom continued to decline on an annual basis, falling by 0.1% in the 12 months to April 2019. This was a slight improvement from the 0.8% annual decline recorded in the previous month (source: Rightmove Real Estate Price Index, 15 April 2019).

But, on a monthly basis, asking prices in the UK rose by 1.1% to an average of GBP 305,449, the highest monthly increase in a year.

Interestingly, there were considerable regional variations, with Wales and pockets of northern England outperforming London and the South of England. This trend is not new, and crept back in 2018. As a result, the highest annual price increase was 3.8% in the West Midlands, followed by a 3.6% increase in Wales and 3% in Yorkshire & Humberside. This contrasts sharply with the British capital, which posted a 2.2% drop in annual asking prices.

It is a challenge to give a clear picture of the UK's residential markets. According to the UK Residential Market Survey of the Royal Institution of Chartered Surveyors (RICS) (March 2019, published on 11 April 2019), the housing market remained sluggish in March, which had been seen in the sales market for several months. With respect to prices, 24% of respondents reported a decrease (rather than an increase) in prices in March. As the survey shows, London and the South-East continued to post the lowest price sentiment, with Scotland and Northern Ireland being the only regions in the United Kingdom to have experienced sustained price growth on a regular basis over the past two months. Looking ahead, at the national level, 15% more respondents expect house prices to be higher in twelve months' time.

"*Brexit remains a major constraint on market activity, with anecdotal evidence indicating that potential buyers are reluctant to engage in the face of increased uncertainty.*" (source: RICS survey, March 2019).



PORTUGAL AND BREXIT

British citizens are increasingly interested in Portugal's immigration scheme, the so-called 'Golden Visa Immigration Investment Programme'. Indeed the latter has proved incredibly popular with investors around the world, with EUR 3.85bn-worth of properties purchased since 2012. Unsurprisingly, Chinese investors account for 60% of total investment volumes (source: Sniper Capital, March 2019).

British citizens (currently still EU citizens) are not eligible to apply for a 'Golden Visa' (April 2019). But if the United Kingdom were to leave the EU, British investors could apply for such a visa in Portugal, subject to any transitional arrangements.

In fact, one of the concerns about a 'hard' Brexit is that British nationals could lose their freedom of movement, residence and right to work in EU countries post Brexit. However, if an access route to the Golden Visa Immigration Investment programme is provided thanks to a 'qualified' real-estate investment in Portugal, then residency for the applicant-investor (and his/her close family) is granted.

Ultimately, access to permanent residency may lead to the issuance of a Portuguese passport after an investment holding period of 5 years. In addition, Portugal permits dual nationality and, as a result, a British citizen could keep his or her British passport, if desired.

As a reminder, the 'Non-Habitual Resident tax regime' (NHR) in Portugal is also very attractive from a tax point of view, as it grants significant tax benefits to non-resident individuals if they take up Non-Habitual Resident status.

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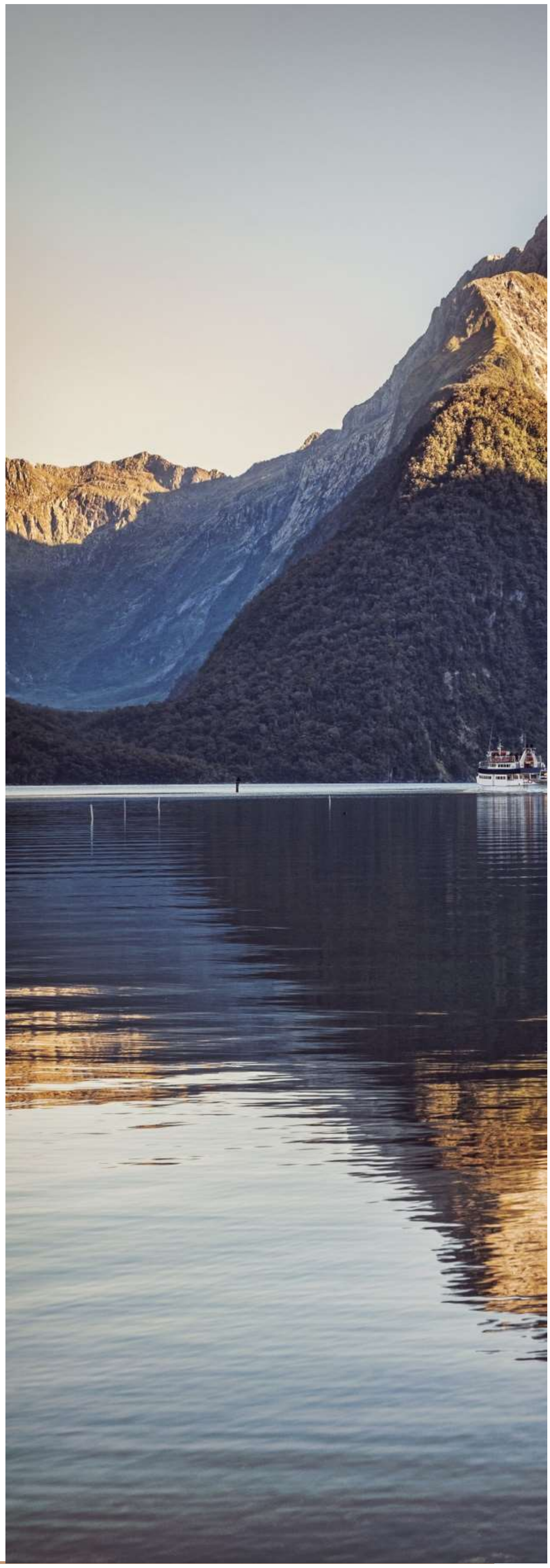

MODESTLY LOWER PRICES FOR APARTMENTS ON THE BELGIAN COAST

The average price for an apartment on the Belgian coast has fallen for the first time since 2014. In addition, the price of a dikeside apartment has also declined somewhat (source: Kustbarometer van de Federatie van de het Notariaat, 19 April 2019). One of the main reasons is that a large stock of 'old' apartments has been 'dumped' onto the market.

An apartment in one of Belgium's coastal municipalities cost on average EUR 259,456 in 2018, exactly 2.4% less than in 2017 (versus +5.7% y-o-y in 2017). Plausibly, a seaside apartment last year still fetched about EUR 40,000 more than an apartment in the rest of Belgium. The average price of flats in coastal municipalities was between EUR 161,000 and EUR 474,000. Unsurprisingly, the most expensive apartments were in Knokke, a trendy beach town.

The average price of an apartment at the sea dike was EUR 320,000 last year, or 1.4% lower than the previous year. Prices ranged between EUR 220,000 and EUR 691,000, with Koksijde and Ostend posting strong increases of 14% and 13.2% respectively.

Belgian notaries have stated that the price decrease is 'relative' (source: Kustbarometer van de Federatie van de het Notariaat, 19 April 2019). Prices of new construction projects are certainly not falling. But far too many old apartments are simply 'thrown away' onto the market. These old apartments, with low ceilings, small terraces or a lack of parking space no longer meet new standards. The main problem is the law on co-ownership. When an apartment building is demolished and rebuilt, all the co-owners must consent. It only takes one person to disagree for the new project to be abandoned.

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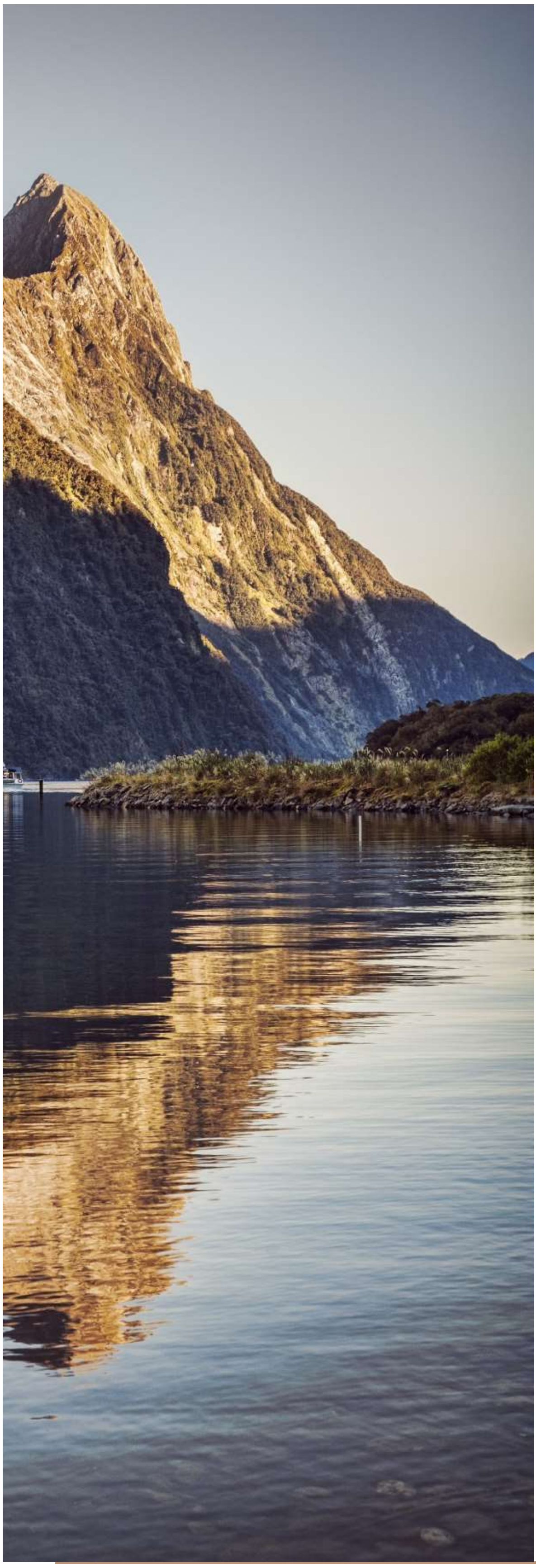


THE WORST PLACES IN AUSTRALIA ...

Prices in Sydney and Melbourne have begun to plummet but they would have to fall considerably more to be anywhere close to the largest fall in the country. Sales data for the past five years show that Australia's biggest real-estate money pits remain concentrated in regional areas and are thousands of kilometres from Sydney and Melbourne.

Towns with the biggest price drops included Newman in the iron ore rich Pilbara region, which is a large, thinly populated region in the north of Western Australia, and Derby, a town in the Kimberley region of Western Australia. Average house prices in these areas more than halved over the five-year period, shrinking from over AUD 600,000 to below AUD 200,000.

Even bigger losses were recorded in Port Hedland, the second-largest town in the Pilbara region, which includes the satellite town of South Hedland. The typical value of a home in the port located 1,523 km north of Perth was AUD 1.27 million in 2013 but this has since shrunk to about AUD 395,000. South Hedland houses showed an average price of AUD 865,000 in 2013, a figure which is today a mere AUD 195,000.

By way of comparison, home prices in Sydney's worst-performing suburb—inner western suburb Annandale—fell by roughly 3% over five years, with the average unit price sliding from AUD 770,000 to AUD 747,500 (source: The Daily Telegraph, 25 April 2019).

Do property cycles still matter?

SLOWING CAPITAL APPRECIATION RETURNS IN THE US

The S&P CoreLogic Case-Shiller 20-city home price index in the US increased by 3.6% y-o-y in January 2019, albeit easing from a 4.1% growth in the previous month. This is the smallest annual gain in house prices since September 2012. Las Vegas reported the biggest increase in house prices (10.5%), followed by Phoenix (7.5%) and Minneapolis (5.1%). In Seattle, annual price gains tumbled from 12.8% in January 2018 to 4.1% a year later. San Francisco saw annual price increases shrink from 10.2% to 1.8% over the same period (source: S&P CoreLogic Case-Shiller, 26 March 2019). Mortgages are very important for home-buyers, and much will depend on future rates.

CONCLUSION

Many housing markets continued to show attractive returns last year, with buyers chalking up reasonable profits in real terms. However, the sky is not the limit, even in the current context of stubbornly low interest rates. A number of overvalued real-estate markets have experienced price erosion in recent months or have been characterized by a slowdown in price growth. In addition, home prices can vary considerably in the same market, a trend which we expect to continue in the coming months.

THE WORLD'S LISTED REAL-ESTATE MARKETS

UPS AND DOWNS ...

In our previous property report published last October, we wrote that the golden years for the listed real-estate markets were '*something of the past*'. Nominal interest rates were on an upward trajectory in 2H18, so share prices fell given the (short-term) sensitivity of Real Estate Investment Trusts (REITs) to nominal and real interest rates alike.

As a result, the bulk of returns (share price evolution + dividends), generated by REITs, were in negative territory in 2018. Continental Europe suffered a very bad performance, with losses up to 16% in euros in spite of a disparity in total returns among European countries, for example France vs. Belgium and Germany. Asian REITs also booked losses of roughly 10% in local currency whereas losses generated by North America REITs were limited to about 3% in dollars (source: Real Estate Securities Investment Guide, BNP Paribas Wealth Management, January 2019).

The bleak picture has improved since January. Year-to-date returns are very good for REIT investors. The total return (gross dividend combined with the evolution of the share price) has reached nearly 14% in Europe and more than 14% in North America and Hong Kong.

France has brilliantly reversed the losses incurred in 2018, with a total return of +19% since the beginning of the year to 25 April. In the 12 months to 25 April 2019, the United Kingdom and France recorded poor returns (in local currency).

Do property cycles still matter?

Over a five-year period, global annualized performances were positive, with most countries posting returns close to (or above) 5%. But total returns of Japanese REITs were disappointing over the same period, barely exceeding 3%.

At the end of January, we changed our recommendation from Neutral to Buy for all REIT markets except the UK. We believed that REITs could recover partially from last year's losses (including over-sold retail REITs), and they thankfully did.

It is noteworthy that real-estate investors remain rather 'zen' when it comes to British REITs, more or less ignoring the negative impact of an unlikely 'hard' Brexit scenario.

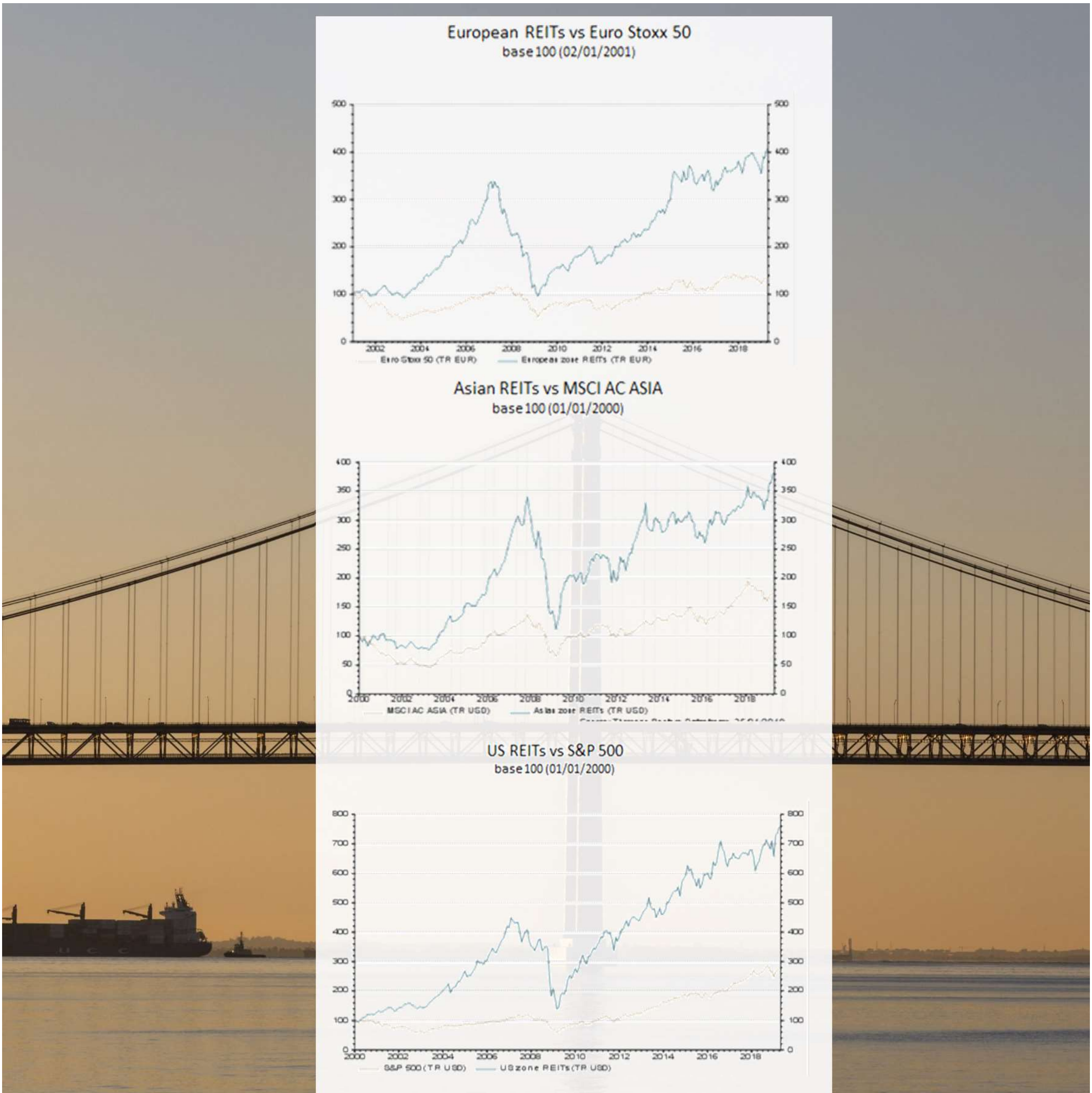
What's more, REIT markets have been outperforming the broader stock markets for years, posting total returns that were a multiple of those carried by common stocks. In recent years, REITs have performed in line with long-term Investment Grade bonds, capitalising on continuously falling interest rates. However, unlike non-indexed bonds, REITs—and real estate in general—provide relatively good protection from inflation.

Table 3: Annual performance of REITs as at 25 April 2019 (in local currency)

Name of index	Currency	1M	YTD	1Y	3Y	5Y
FTSE EPRA/NAREIT Europe ex-UK	EUR	0.05	12.26	8.63	8.32	11.85
FTSE EPRA/NAREIT Europe	EUR	0.53	13.62	6.24	5.41	9.31
FTSE EPRA/NAREIT France	EUR	3.76	19.33	1.72	3.26	6.41
FTSE EPRA/NAREIT Germany	EUR	-4.48	8.27	13.86	15.85	20.34
FTSE EPRA/NAREIT UK	GBP	2.50	12.91	-0.82	2.77	4.85
FTSE EPRA/NAREIT Belgium/Luxembourg	EUR	0.15	12.88	22.10	12.37	14.45
FTSE EPRA/NAREIT Asia	USD	-1.21	11.56	9.47	6.92	5.31
FTSE EPRA/NAREIT Japan	JPY	-2.21	7.61	6.50	0.50	3.22
FTSE EPRA/NAREIT Singapore	SGD	2.55	13.65	5.14	10.37	6.86
FTSE EPRA/NAREIT Hong Kong	HKD	1.30	18.27	13.85	16.72	10.23
FTSE EPRA/NAREIT North America	USD	0.18	14.83	21.44	6.00	7.87

Source: EPRA, 25/04/2019

Charts 2, 3 and 4:
REIT performance in Europe, North America and Asia compared to the broader stock markets



Source: Thomson Reuters Datastream, 25/04/2019

Do property cycles still matter?

We believe that the recent and unanticipated decline in long-term nominal (and real) interest rates has largely driven this strong performance. As previously mentioned, in the second half of last year, many investors were concerned about a possible increase in nominal interest rates. It is true that higher rates can lead to an increase in the cost of borrowing, while other forms of investment may also become more attractive than listed real estate (e.g. high Investment Grade Corporate bonds).

TWO PARALLEL ASSET MARKETS

REITs are more rapidly affected by higher interest rates than by the value of their properties because of their high liquidity. Broadly-speaking, some major questions could be raised by the existence of parallel property markets: the direct private market and the public market for REIT shares:

- Which asset market(s) should investors favour when considering a real-estate investment? Public? Private? Both? We recommend investing in both markets, to allow for a different degree of liquidity within a property portfolio.

- Is it possible to trade across two markets in order to make profits more rapidly? We believe that an 'arbitrage' strategy is possible, which is precisely what a number of asset managers have been doing in recent months, i.e. targeting listed property portfolios at a discount, and taking them privately with the aim of unlocking hidden value thereafter.

- Do the two asset markets value the same underlying assets differently? Yes, and this is the reason why REITs could either trade at a premium or at a discount to net asset values (NAVs). This question underlies the second question.

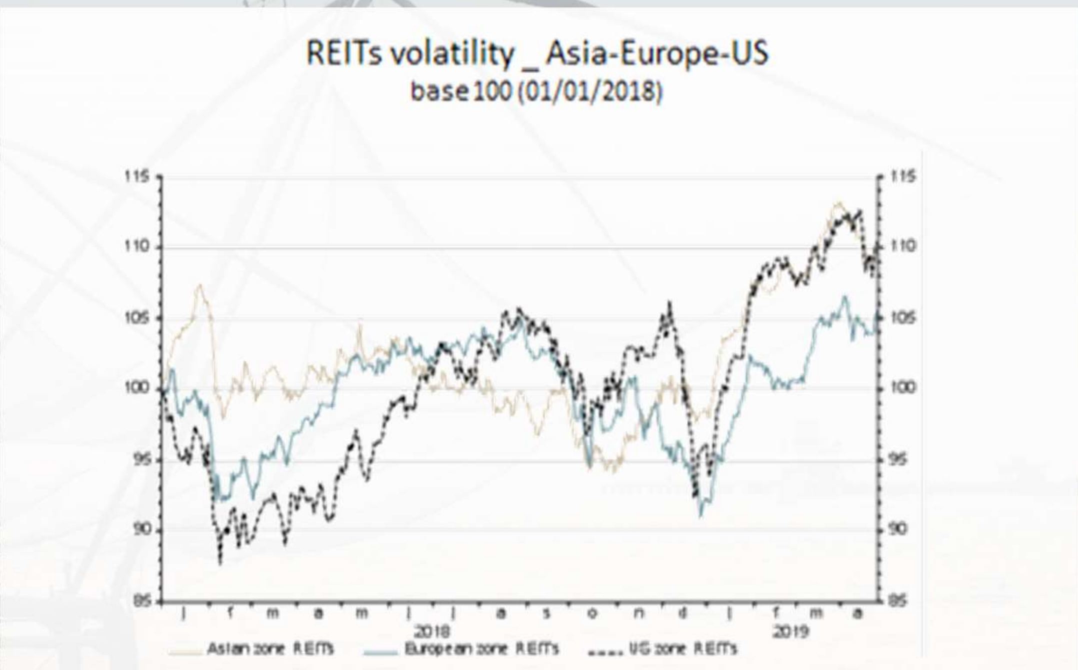
Do property cycles still matter?

OUTLOOK FOR REITS

After a solid performance in the first quarter, we believe that the 1Q19 performance will not be repeated easily in the coming months. Interest rates are close to zero and real-estate cycles are gradually ending in many parts of the world, thus capping values and rental growth. It is therefore quite a challenge to find catalysts for sustainable share price growth. Moreover, fresh volatility must never be ruled out.

In a way, we believe that REITs could now be considered as pure income securities rather than growth securities. This means that REITs pay a larger portion of their value to investors in the form of current income, so they are perceived as attractive dividend plays. Indeed, gross dividend rates still fluctuate at around 4% on average (for example in Europe) which leads to an attractive spread with 'risk-free' long-term interest rates. Currently, the dividend rate is the main reason to invest in REITs.

Chart 5: REIT volatility since January 2018



Source: Thomson Reuters Datastream, 25/04/2019

A NEW REIT REGIME LAUNCHED IN PORTUGAL

On 28 January 2019, the Portuguese government published Decree-Law No. 19/2019, introducing the legal framework for REITs that came into force on 1 February 2019. The Portuguese REIT is the so-called '*Sociedades de Investimento e Gestão Imobiliária*' (Real Estate Investment and Management Companies or 'SIGI', source: Galvão Teles, Soares Da Silva & Associados, February 2019). The tax regime allows for exemptions (or tax reductions) on REITs, for the benefit of their shareholders, thereby harmonising the Portuguese tax regime with other international tax regimes.

The introduction of a legal regime for REITs was the subject of extensive discussions in Portugal, its approval having been under consideration since 2015, when the Portuguese parliament authorized the Portuguese government to introduce the regime.

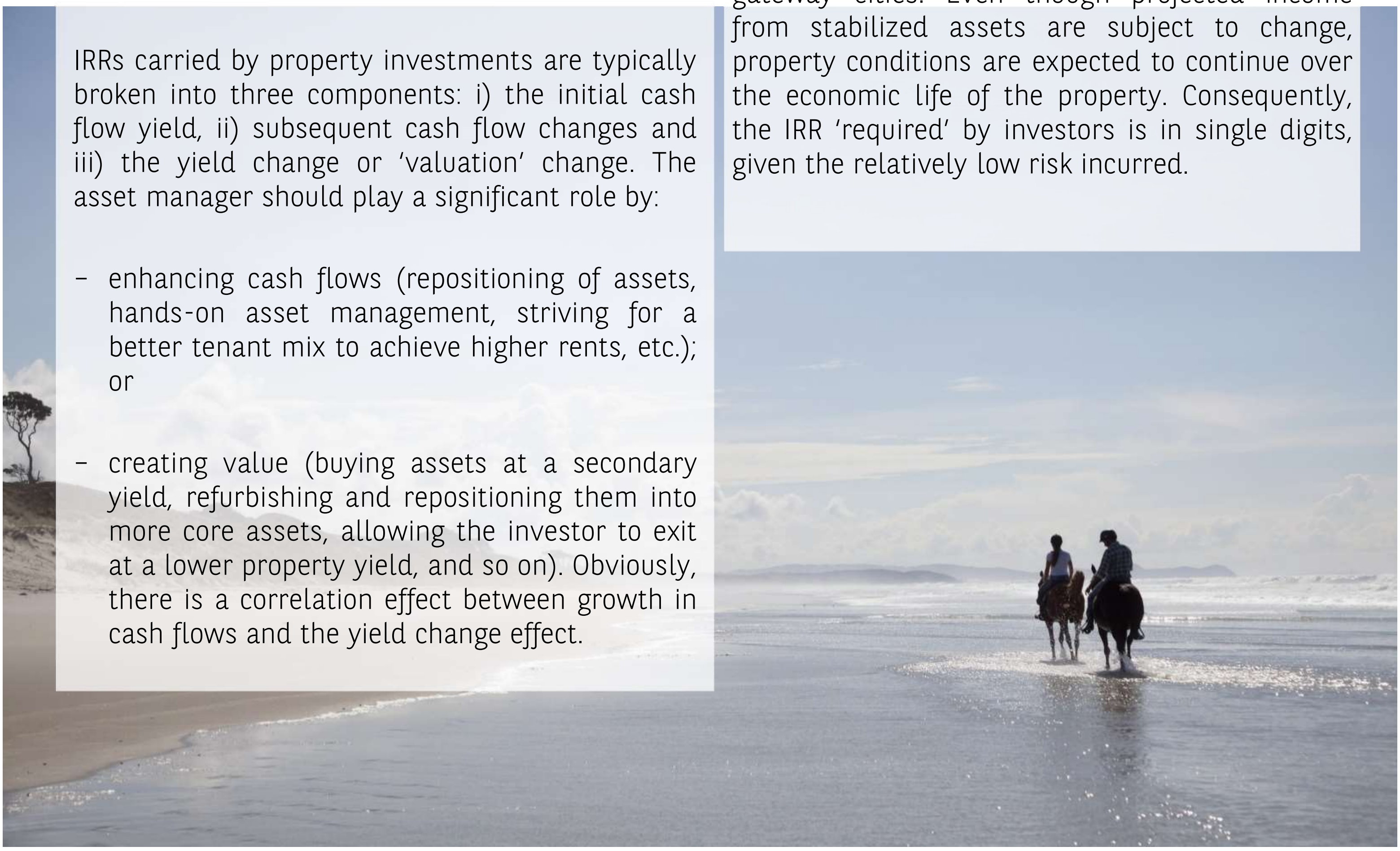
CONCLUSION

We reiterate our 'Buy and Hold' strategy—with the exception of UK REITs—because REITs offer a higher gross dividend yield compared with other (fixed income) asset classes like Investment Grade bonds. In addition, the financial health of most REITs has improved since the 2007 credit crisis, resulting in reasonable LTVs. Share price appreciation could be modest in the coming months in view of the very strong rebound in 1Q19.

REAL-ESTATE INVESTMENT STRATEGY

WHAT SHOULD A PROFESSIONALLY-MANAGED PROPERTY PORTFOLIO LOOK LIKE?

We believe that a professionally-managed property portfolio should include a significant allocation to 'non-core' or 'value-added' properties. So within the real-estate portfolio, there may be both 'core' and 'non-core' components, with the latter being investment vehicles, such as value-added or opportunistic funds. These private vehicles are relatively illiquid, or totally illiquid throughout the holding period. And they may include domestic and/or international investments.



IRRs carried by property investments are typically broken into three components: i) the initial cash flow yield, ii) subsequent cash flow changes and iii) the yield change or 'valuation' change. The asset manager should play a significant role by:

- enhancing cash flows (repositioning of assets, hands-on asset management, striving for a better tenant mix to achieve higher rents, etc.); or

- creating value (buying assets at a secondary yield, refurbishing and repositioning them into more core assets, allowing the investor to exit at a lower property yield, and so on). Obviously, there is a correlation effect between growth in cash flows and the yield change effect.

This is why it is so important that the asset manager has an impeccable track record (to convince investors). Non-core properties should generate double-digit returns—after reasonable leverage—to compensate for illiquidity during the holding period and, of course, for the additional risk borne in relation to core properties.

By contrast, core real estate includes high-quality, 'stabilized', income-producing properties in gateway cities. Even though projected income from stabilized assets are subject to change, property conditions are expected to continue over the economic life of the property. Consequently, the IRR 'required' by investors is in single digits, given the relatively low risk incurred.

Do property cycles still matter?

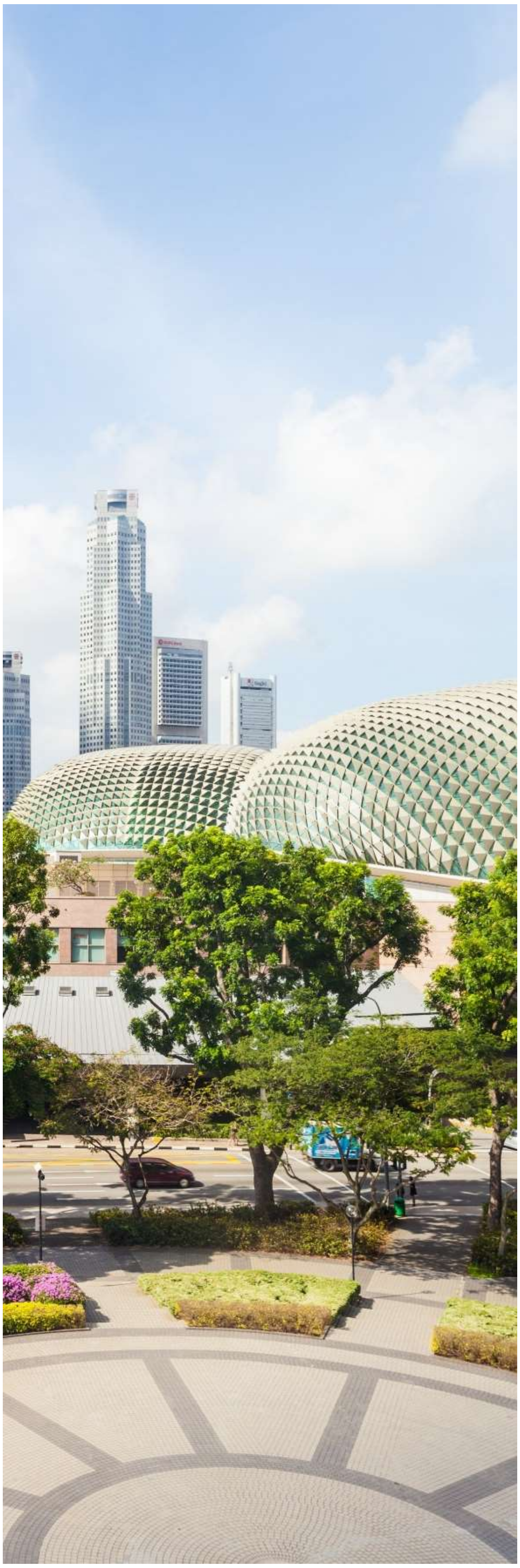
OUR REAL-ESTATE INVESTMENT STRATEGY

Our strategy for real-estate investors remains consistent, even if market conditions are not straightforward. Investors could do one of the following.

- Buy physical properties in top-tiered property markets. This is certainly the case for first-class real estate in Europe (including the United Kingdom at a later stage), but the US and Asia should not be excluded. This strategy could be used by investors having a preference for lower-risk assets with an income investment objective, and who accept capital appreciation growth in line with expected inflation. As such, secondary (lower-tiered) markets should be avoided, but investors could move into secondary assets in top locations. As a reminder, a secondary location is near or adjacent to a prime location;

- Purchase units in a 'real-estate private equity fund', with an asset manager who creates value (cheaper acquisitions thanks to a strong sourcing platform, identification of 'off-market' transactions, converting or repositioning existing buildings to allow for yield compression, etc.). This strategy is suitable for investors with a growth investment objective, which implies a relatively long-term investment horizon with no immediate need to use the cash invested.

Do property cycles still matter?



In some cases, the same investor may define both of these objectives for different parts of an investment portfolio.

We are convinced that investors should include listed real-estate investments in their property portfolios, even though **REIT share values may reflect the characteristics and valuation of the stock market** rather than that of the physical property market, at least in the short term. That said, investors receive a higher portion of REIT values in recurrent cash income (dividends) compared with other asset classes, and they offer a degree of liquidity within a property portfolio.

REAL-ESTATE RECOMMENDATIONS

As mentioned, we are Positive on the value-added real-estate segment across Europe. We keep a Negative stance on UK REITs due to deteriorating conditions in the country's office markets (particularly London) and we are Negative too on a number of emerging markets in Latin America.

Do property cycles still matter?

OUR REAL-ESTATE STRATEGY BY REGION

NORTH AMERICA

Segment by region	Previous opinion	Current opinion
Top-tiered commercial	Neutral	Neutral
Lower-tiered commercial	Neutral	Neutral
Residential	Neutral	Neutral

EUROPE

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

EMERGING MARKETS (EMERGING ASIA & LATIN AMERICA)

Segment by region	Previous opinion	Current opinion
Commercial	Neutral	Neutral
China Top-tiered residential	Neutral	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.

Do property cycles still matter?

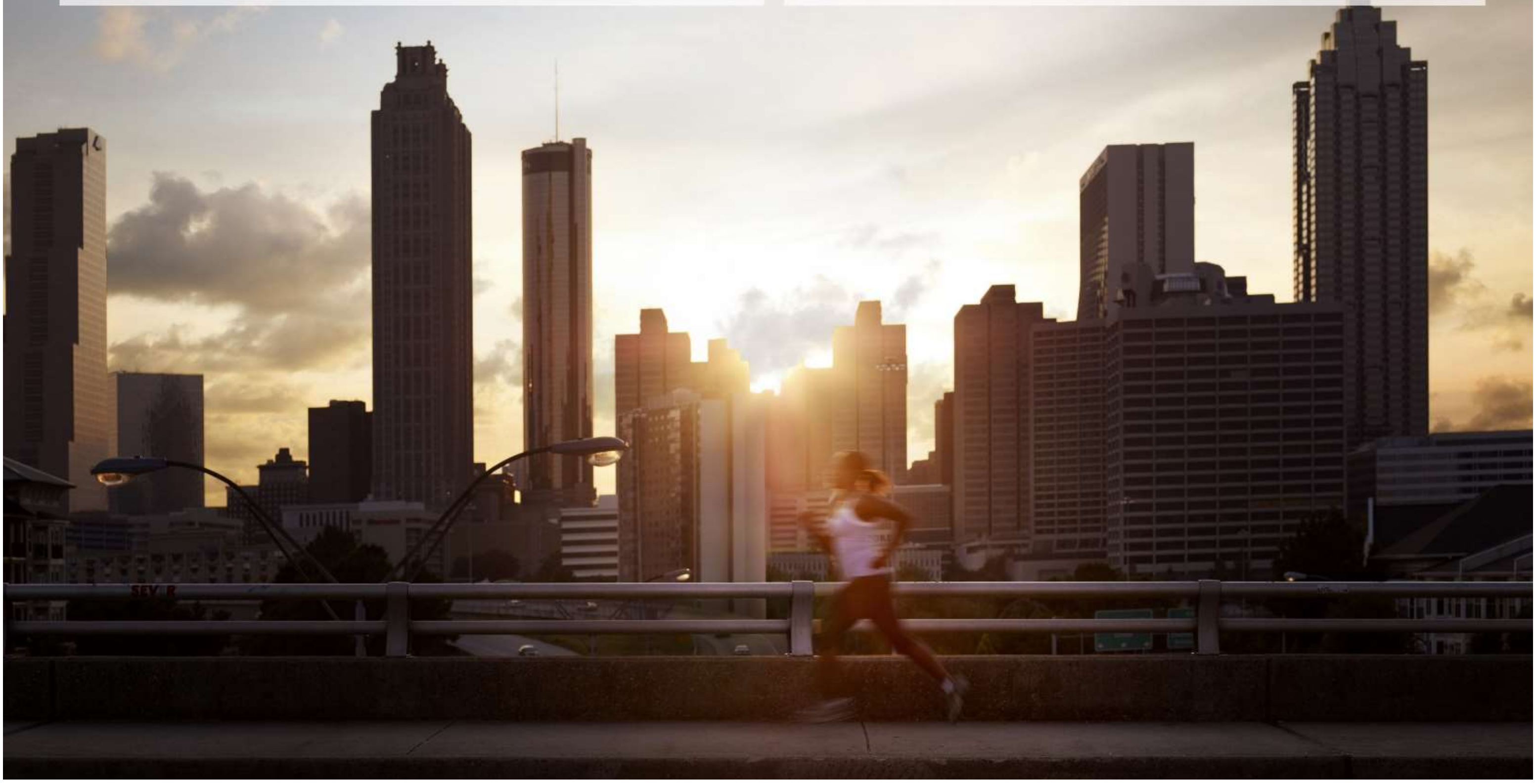
CONCLUSION

In this new real-estate report, we consider whether property cycles still exist. The question seems aggressive, but is pertinent. How is it that real-estate returns have continued to increase in recent years in most residential and commercial property markets worldwide? Why haven't we seen a real correction, as in previous decades?

We believe that global financial markets, driven by monetary policy of central banks, continue to support property markets. Nominal interest rates—especially real interest rates—are so low (or negative) that investors are looking for a better return offered by other asset classes, such as real estate. Moreover, property yields remain significantly higher than so-called 'risk-free' rates.

Nevertheless, it is impossible for real-estate cycles to simply disappear from the planet. But they can probably be 'extended' by monetary policy. In any case, real-estate investors should be cautious about upcoming return projections. Perhaps they need to slightly revise down their expectations for tier-1 assets, while successful asset managers need to continue to create value in their property investments, through the so-called 'value-added' strategy.

Even if property returns were to decline slightly in the future, real estate could remain attractive compared with other asset classes, because the 'relative' aspect of a real-estate investment—namely the positioning of direct and listed property in a diversified wealth portfolio—remains essential.

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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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Author: Pol Robert Tansens, MRICS
Head of Real Estate Investment Strategy
BNP Paribas Wealth Management

Director of Publication: Claire Roborel de Climens
Head of Private Investments and Real Estate
BNP Paribas Wealth Management

English editor: Charlotte Standring
English Translator for the Central Offering Team
BNP Paribas Wealth Management

Graphics: Marion Chaix de Lavarène
Marketing Specialist
BNP Paribas Wealth Management

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