INTRODUCTION

UK real estate offers a wide range of investment opportunities across all strategies, and is capable of being accessed directly or indirectly, through debt or equity. Whilst this paper will focus on the attributes of direct property investment as an asset class, ultimate investor returns will also be driven by market uncertainty, funding costs, investor sentiment and exchange rate fluctuations.

The latest economic forecasts from BNP Paribas show that whilst 2016 is expected to see a slowdown in GDP growth, the coming 5 years are forecast to deliver robust growth, with London continuing to be a key driver.

KEY ECONOMIC VARIABLES

<table>
<thead>
<tr>
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<th>15</th>
<th>16*</th>
<th>17*</th>
<th>18*</th>
<th>19*</th>
<th>20*</th>
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</thead>
<tbody>
<tr>
<td>UK – GDP growth</td>
<td>2.3</td>
<td>1.7</td>
<td>2.1</td>
<td>2.2</td>
<td>2.2</td>
<td>2.3</td>
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<tr>
<td>UK – Employment growth</td>
<td>1.4</td>
<td>0.9</td>
<td>1.0</td>
<td>0.2</td>
<td>0.4</td>
<td></td>
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<tr>
<td>London – GDP growth</td>
<td>3.5</td>
<td>2.7</td>
<td>2.9</td>
<td>2.7</td>
<td>2.9</td>
<td>3</td>
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<tr>
<td>London – Employment growth</td>
<td>2.9</td>
<td>2.1</td>
<td>1.9</td>
<td>0.9</td>
<td>0.9</td>
<td>1.1</td>
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Whilst we are currently experiencing enhanced market uncertainty, it is important we remain balanced in our views on real estate and attempt to look beyond short term volatility to long term performance generated by the asset class. As such, the core investment credentials of real estate become particularly relevant when discussing relative safe havens and a future return of capital during times of heightened risk.

Many commentators have focussed on stock market volatility as an indication of forthcoming events, however, stock markets are naturally characterised by high volatility and swings are common over cycles and this does not necessarily imply a forthcoming recession.

Furthermore, stock market performance has a very low correlation with underlying GDP growth and as such is often a poor predictor of the next major shock, however, short term market movements can change perceptions of risk and attitudes towards investment strategies.

Real estate investment strategies, or styles, can be categorised by their position on the risk/return spectrum, and these range from core income producing real estate, perceived to be relatively low risk, to opportunistic and development where risk is elevated in return for greater potential rewards. At an overall fund level, INREV provide a useful categorisation of real estate strategies according to their target returns, income component, exposure to development and levels of gearing that maintains relevance across cycles.

INREV STYLE CLASSIFICATION

<table>
<thead>
<tr>
<th></th>
<th>Core</th>
<th>Value added</th>
<th>Opportunistic</th>
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<tbody>
<tr>
<td>Target of non-income producing investments as a percentage of fund GAV</td>
<td>&lt;15%</td>
<td>15%-40%</td>
<td>&gt;40%</td>
</tr>
<tr>
<td>Target return derived from income</td>
<td>&gt;60%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Target of redevelopment exposure as a percentage of fund GAV</td>
<td>&lt;5%</td>
<td>5%-25%</td>
<td>&gt;25%</td>
</tr>
<tr>
<td>Maximum loan-to-value</td>
<td>&lt;60%</td>
<td>40%-60%</td>
<td>&gt;60%</td>
</tr>
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This paper will now explore the strategic investment case for real estate in more detail by examining the major drivers of returns from the asset class and answer the question, why UK real estate?
1. STABLE INCOME RETURNS

UK property has delivered a consistent and stable income return over time as shown by the chart below. Over the 15 years to end 2015 UK property delivered an annualised 7.9% per annum of which 6.1% was delivered by income and 1.7% delivered by capital growth. Income from property can be seen to be consistent over cycles even during times of extreme economic distress as experienced in 2008. Capital growth introduces volatility into returns, highlighting the importance of timing when relying on capital growth to enhance returns.

2. REAL ESTATE LIQUIDITY

Liquidity in real estate markets can be defined in numerous ways and will vary across investors depending on their investment thesis and time horizon. Market liquidity can be defined in terms of overall investment volumes (cash or floorspace transacted), time and cost to transact, diversity of players in a market or turnover (activity as a % of market stock). A recent research study by the IPF confirmed that there was a statistically strong relationship between market liquidity (as defined by volumes) and pricing.

However, the list of the most liquid markets globally do differ between those which exhibit the largest cash amounts transacted and those which have experienced the largest amount of turnover as a % of stock, as seen below.

Having said that, liquidity will always be perceived to be highest in the large global cites such as London, NYC, Tokyo and Paris which by definition will drive further activity attracting yet greater quantities of capital from investors seeking global diversification. These cities are also seen as long term investment destinations as less stock is traded as a percentage of the total market size, hence providing a safe haven for capital.

Real estate is considered an illiquid asset class, particularly when compared with equities and bonds. However, liquidity varies according to lot size, sector and location, with locations such as the City and West End of London attracting a wide range of capital both domestically and globally.

During the market downturn of 2008, the UK, and specifically Central London, were seen by many global investors as a safe haven offering capital preservation. As such, the UK maintained a level of liquidity during a time when many other markets, particularly in the Eurozone, experienced a drying up of investment activity.
This is clear from the chart below, during Q1 and Q2 2009 investment activity was very low in most major European markets except London which continued to attract demand for real estate even in the face of extreme economic distress.

### EUROPEAN MARKETS: LIQUIDITY €M

Source: RCA

The UK market continues to attract an increasing amount of capital from a wide range of investors, both domestic and cross border. The proportion of cross-border investors in the UK office market grew significantly from 2001 to 2007, and now represents in excess of 50% of all buyer activity in 2015. UK institutions were the dominant investor type in 2001 and have maintained a strong position in the UK market across the cycle.

### COMPOSITION OF INVESTORS IN UK OFFICES

Source: RCA

#### 3. RISK AND RETURN

Direct investment in UK real estate is typically characterised as exhibiting less volatility (and risk) than UK equities, and within the asset class offers a wide range of risk/return opportunities, in part due to the high income component of total return which typically reduces volatility in markets where long term performance is more driven by income than capital appreciation.

#### 4. DIVERSIFICATION

As shown by the table below, when included in a multi-asset portfolio, UK property provides additional diversification benefits when combined with UK equities and bonds. This relationship holds true on both a national and global level and is driven by market liquidity and asset pricing. Real estate values are not as impacted by short term market volatility that is reflected immediately in the pricing of both equities and bonds.

Portfolio construction can further exploit the diversification benefits as sectors and locations exhibit different levels of correlation with each other, and within real estate; the more assets added to a portfolio, the more specific risk is diversified.

### TOTAL RETURN CORRELATIONS 1981–2014

<table>
<thead>
<tr>
<th></th>
<th>UK EQUITIES</th>
<th>UK BONDS</th>
<th>UK PROPERTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Equities</td>
<td>1.0</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>UK Bonds</td>
<td>1.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>UK Property</td>
<td>1.0</td>
<td></td>
<td></td>
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Source: MSCI, Macrobond

#### 5. INFLATION HEDGING

Real estate is often described as providing a hedge for inflation but the relationship between property values and rents, and the underlying rate of inflation is variable. Generally, given that long term real estate returns are driven by a strong income component, the degree to which property can be considered a hedge for inflation is dependent on the asset level specifics of lease structures and income duration.

Some leases may be directly linked to changes in RPI (often with a cap and collar) and others may be reviewed to an open market valuation. The former cashflow clearly provides a direct correlation with UK inflation. This type of structure is often more prevalent in France and Germany where rental payments are commonly linked to a national price index.
Whilst the correlation between values and inflation is variable, it is clear for the chart below that property delivers strong long term real returns.

![ALL PROPERTY TOTAL RETURNS V INFLATION (RPI)](chart.png)

Source: Oxford Economics/MSCI

**6. A REAL ASSET**

As a real asset, returns from direct real estate will be somewhat protected on the downside as there is always likely to be a residual value to the real estate, even in the event of a tenant failure and cessation of income. This is unlike holding an equity investment whereby all future returns will cease in the event of company failure, or on expiry of a bond.

**7. ACTIVE MANAGEMENT**

Given the tangible nature of real estate, it lends itself to active management which can further enhance rental and capital value for the investor.

Furthermore, there are a wide range of activities that can be carried out to a real estate asset, positioning it in a different place on the risk/return spectrum. Whilst the specific location of an asset cannot be changed, the locale can change over time (as seen with emerging submarkets) and additional risks can be taken on board that move the opportunity up the risk/return spectrum. The objective of moving up the risk curve is to accept a level of risk in the knowledge that management can resolve issues with either the asset or the financial structure, and after doing so can exit at core pricing, hence creating value. This can be achieved by a range of activities including letting vacant space (existing or developed) or through capital expenditure and refurbishment which can be accretive to future performance and value creation.

**CONCLUSION**

During a time of considerable market dislocation and falling commodity prices, the case for real asset exposure becomes more compelling. As equity markets continue to fall, the characteristics of real estate outlined in this paper further highlight the benefits of investing in a real asset such as property, offering both bond-like and equity returns and delivering strong long term risk adjusted performance.

As we have seen, UK real estate offers a wide range of opportunities across sectors, regions and strategies, however, in addition to the factors that determine where an asset might reside on the risk/return spectrum, there are additional exogenous risks that should be factored into the underwriting of pricing and future real estate performance.

BNP Paribas Real Estate constantly monitors these risks and factors the potential impact of market ‘pollutants’ into its views of future market performance.

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