It is 2017 and the world has changed.

In many ways we are in uncharted territory, both economically and politically. This property cycle has been shaped by the unprecedented actions of central banks following the global financial crisis, and will be defined further by the fallout of various political shocks of 2016.

The ‘Cycology’ of the real estate market is constantly changing and therefore the methods we use to understand it must also adapt however market dislocation shouldn’t be seen as a negative, dislocation creates opportunity.

Models and scenario analysis can help us to understand the market, but these are driven by historical relationships – few predicted the severe decline in real estate values in 2008. In a volatile and uncertain world models cannot account for every variable that drives performance. It is no longer sufficient to assume that the market will simply ‘revert to mean’.

It is this recognition of the need to evolve that has led BNP Paribas Real Estate to partner with Ipsos MORI to launch Cycology – a new study and the first of its kind.

Taking something from the ‘wisdom of crowds’ approach, Cycology acknowledges that sentiment is the major driver of the property market, and that it is important that this impact is better understood and, if possible, quantified.

Cycology analyses the data of cycles past. Traditional forecasting then combines with unprecedented access to the sentiment of real estate leaders and experts to offer a unique and unparalleled insight into what lies ahead for the UK property market.
Qualitative inputs are most valuable if they come from a larger number and wider range of people, and particularly those with the greatest market experience and expertise. This is why we have chosen to speak to the most senior investors, occupiers and academics, independently of each other and without the comfort of their own in-house forecasting models, to understand the current real estate cycle.

These senior investors, occupiers and academics were interviewed in depth by Ipsos MORI. Direct quotations from these interviews can be found throughout this report, giving a fascinating insight into the drivers of the last real estate cycle, how the global financial crisis has changed the behaviour of market participants, and most importantly, illuminating the future in a way that quantitative forecasts alone cannot.

For 10 years we have been in an economy that is very different to that of the previous 150 years. Politically, the world has changed dramatically. These changes make it very difficult to understand what’s going on, and politically, the world has changed dramatically as well...

This report is the first of its kind. We have recognised that you cannot just forecast based on historic data and that sentiment is critical when it comes to making real estate decisions.

Thus, Cycology highlights the themes and drivers that investors and occupiers believe will shape our future. So, this report isn’t just full of charts, graphs and historical analysis, although important, but also draws on the psychology of those who shape the market to build a picture of the factors that will drive the future.

The world has changed dramatically and it feels like the pace of change is accelerating further. We recognise this, and have reacted quickly to present a new way of thinking about the future of our market. As the real estate adviser for a changing world, we are best placed to advise both investors and occupiers on what to expect and how to prepare for tomorrow, today.

John Slade
CEO
BNP Paribas Real Estate UK
IT IS A CHANGING WORLD
Uncertainty is certain, and is now the new normal.

THE CYCLES OF THE PAST ARE HISTORY
And history is no longer a reliable guide to the future.

PEAKS AND TROUGHS BECOME BUMPS
The next cycle will have less pronounced peaks and troughs and will be shorter and bumpier.

ENTER THE NEW FUNDAMENTALS
Supply, demand, and covenant strength are still important, but capital flows, politics, currency and debt are now seen as equally critical determinants of price going forward.

A POLITICAL CYCLE
In contrast to previous cycles, the next cycle will see economics driven by political change.

POLITICAL CORRECTION
The market was adjusting before the shocks of 2016 and a price adjustment was already underway. The changing political landscape has accelerated this correction.

GLOBAL SHOCK FACTOR = LONDON X FACTOR
Investor responses to the Global Financial Crisis, and the ongoing geopolitical and economic uncertainty have all strengthened London’s safe haven status.
LACK OF REGULATION TO GREATER REGULATION
Following the crisis, industry governance has increased both internally and externally. Tighter risk management in the decision making process and regulatory change has sought to mitigate the impact of future shocks on the financial system.

INVESTORS ARE SUSPICIOUS OF EVERYTHING
Investors believe they are more risk averse than in 2008, but are concerned about the pace of change, regulators, politicians, other investors and worry that the younger generation will not learn from the past.

‘SHOCK BLOCKS’ SINCE 2008
Investors feel they have learned lessons from 2008 and are seeking to insulate their portfolios against the impact of future shocks. Focussing on less volatile markets like distribution warehouses, residential, hotels, leisure and prime retail.

OCCUPIERS ARE PLACING GREATER VALUE ON WORKFORCE HEALTH, PRODUCTIVITY, WORK LIFE INTEGRATION AND SUSTAINABILITY
Things investors find difficult to monetise and value.

BRIDGING THE GAP
Investor and occupier needs should be more closely aligned. As the real estate adviser for a changing world, ahead of the game and advising both, we are in a position to bridge the gap.

OCCUPIERS ARE EMBRACING THE THINGS INVESTORS FEAR
Millennials, technology, flexibility, change and the pace of change. Are occupiers in a more powerful position as a result?
CONTENTS

THE CYCLES OF THE PAST ........................................ 7
REAL ESTATE HAS EVOLVED .................................. 10
THE FORECASTING CHALLENGE ............................ 12
THE GLOBAL FINANCIAL CRISIS .......................... 13

THE PRESENT – A NEW ‘NORMAL’ ...................... 15
INVESTORS ......................................................... 16
RISK MANAGEMENT ........................................... 21
REAL ESTATE LENDING AND GOVERNANCE ...... 22
OCCUPIERS ....................................................... 25
CHANGES DUE TO TECHNOLOGY ....................... 25
DEMOGRAPHIC CHANGE .................................. 26
SUSTAINABILITY ................................................. 27
MISMATCHED EXPECTATIONS? ......................... 27

THE FUTURE ..................................................... 29
WILL THIS NEW ‘CYCLE’ BE DIFFERENT? ............ 30
THE IMPACT OF POLITICAL SHOCKS – ......... 32
BREXIT AND TRUMP ......................................... 32
WHAT DOES THIS MEAN FOR ....................... 34
MARKET PERFORMANCE? ............................... 34
HOW WILL WE SEE FUTURE SHOCKS ......... 35
COMING IN THE FUTURE? ............................... 35
LEAD INDICATORS AND FUNDAMENTALS ........ 35
FUTURE RISKS .................................................. 36
LONDON THE GLOBAL CITY ......................... 37

CONCLUSION .................................................. 39

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*Plus three anonymous real estate leaders
“No man ever steps in the same river twice, for it’s not the same river and he is not the same man.”

HERACLITUS
GREEK PHILOSOPHER
BORN 535BC
The Cycles of the Past

Of course, the only certainty in life is change. Nevertheless, it is tempting in 2017 to feel that change is influencing everything that we do. Recent events, such as the UK’s decision to leave the European Union and the election of Donald Trump, represent scenarios that once seemed unlikely but are now a reality that, while impossible to model, will impact the performance of our marketplace. These intertwine with the transversal themes we are all aware of – our changing demographics, global economy and technological expertise – to create an increasingly wide range of variables.

In order to better understand the future impact of significant events, sentiment becomes a more critical component of the forecasting process than ever before. After all, how people feel towards the future is reflected in their actions today.

Over the last 35 years (the MSCI universe history), change has been momentous on a range of axes: political, technological and the nature of conflict, and manifests in the changing structure of economies.

The behaviour of the real estate market is intrinsically linked with economic performance, and these forces have interacted to produce an unprecedented building cycle in many cities, most notably in Central London.
1989-1998
- Low £/$
- Changing use classes fuelled spec development
- Cheap money
- Falling unemployment
- 14 years of positive total returns

1999-2008
- Markets over overbuilt
- Assets over leveraged

2009-2018
- Low inflation
- Cheap money
- Real assets
- Falling £
- Conditions supportive of property performance?

BLACK WEDNESDAY
1992
UK EXIT FROM ERM

DOT COM CRASH
2000

SUBPRIME CRISIS
2007-09
REITS ESTABLISHED 2007

SOVEREIGN DEBT CRISIS
2010-PRESENT

BOSNIA WAR
1992-95

KOSOVO WAR
1998-99

9/11 ATTACKS
2001

IRAQ WAR
2003-11

SYRIAN CIVIL WAR
2011-PRESENT

GORDON BROWN
2007-10

TONY-LIB DEM COALITION
2010-15

DAVID CAMERON
2015-16

THERESA MAY
2016-?
Real estate performs a critical role in the portfolios of both investors and occupiers and its function is constantly under pressure from the changing environment.

For investors, real estate has evolved into a major asset class. It performs different purposes in a portfolio from institutional to sovereign wealth funds, and offers a range of strategies from core to opportunistic. Real estate can now be accessed by directly acquiring properties, through a variety of other fund structures or through the liquid REITS market.

The ability of real estate to provide diversification benefits in a multi-asset portfolio has led to institutional allocations to continually increase, up to 8.9% of assets under management from 7.6% in 2012, according to a recent Preqin report (PREQIN: Real Estate Spotlight December 2016). According to the INREV Investor Intentions Report 2016 the average target allocation to real estate actually sits at 10.3%.

In times of economic uncertainty real estate is viewed as offering a degree of stability due to its income, yet also offering long term capital growth. Its attractiveness does change over time due to factors such as the yield spread to government bonds, but the core characteristics of the asset class in the UK do not vary dramatically with the cycle:

- Strong long term performance supported by income
- Diversification in a multi-asset portfolio due to low correlations with equities and bonds
- Performance enhancement through active management
- Liquidity provides for price discovery even in times of distress.

The structure of the real estate market itself is also constantly changing in response to occupier and investor demands. The changing weights in the IPD index over the past 35 years highlight a number of broader trends, and underline the problem with assuming that real estate performance will be mean-reverting:

- Standard retail in the South East is moving in the opposite direction to the rest of the UK in line with changing consumer behaviour, the increasing dominance of London and a focus on the large cities and dominant centres
- The retail warehouse sector has grown from almost zero to 13% of the MSCI universe
- Distribution warehouses have displaced some retail due to ecommerce, and the manufacturing base in the UK has reduced
- City office weights have fallen from a peak of 17% in the 80s to 4% in 2015, reflecting the changing nature of ownership in the City
Not only has the structure of the market changed but so has the extent to which industry data is representative of the ‘true’ real estate universe. This can cause challenges for the industry as benchmarking encourages a herding mentality whereby portfolio allocations to different sectors and regions are dictated partly by the composition of the benchmark. This behaviour is not always appropriate when investing in a heterogeneous asset class such as real estate, and will not necessarily be accretive to performance where structural change has driven a bigger gap between the winners and the losers in many sectors as we have seen in retail.

The increasing ownership of UK property by overseas investors, who are often not included in market benchmarks, reduces our understanding of the whole market. The following graphic shows the increase of global capital active in the UK market from almost 10% in 2002 to almost 50% in 2016. This capital is not necessarily investing to outperform an industry benchmark and is often focussed on the income producing ability of the asset class. As such income duration and income quality become more critical, driving increasing demand for certain assets such as distribution warehouses and prime offices.

As you can see in our graphics, over the last 15 years the number of new leases granted for 20-years or greater has more than halved, while the number of new leases of between five and 15 years has doubled, as has the incidence of break clauses in new leases. Not only has the duration of income structurally reduced but the incidence of default among tenants has also risen. For the three major sectors (retail, office and industrial) the default rate has almost trebled from circa 1% in 2002 to 3% in 2016, reaching a peak following the financial crisis as many businesses failed, especially in the retail sector.

Source: MSCI
THE FORECASTING CHALLENGE

Forecasting real estate markets is challenging, especially during periods of heightened uncertainty when transparent markets are adjusting quickly in reaction to real time information and events. Unsurprisingly, forecasting accuracy varies across cycles and markets.

What seems constant, however, according to the Investment Property Forum, is that forecasters tend to avoid ‘big numbers’ and so almost always underestimate future market movements. Furthermore, organisations will typically make use of the same data and use a similar methodology. They do however use a varying amount of sentiment to tweak their numbers, but in our view, a more significant qualitative overlay is required to improve forecasting accuracy especially during periods of significant change.

A further key finding from the analysis of IPF Consensus Forecasts was the difference in accuracy between the forecasting of rents and values, whereby the market could more accurately forecast rents (and the underlying fundamentals) than capital values.

It is interesting that there is a tendency in our industry to anchor views on capital values, the driver that the market does not manage to forecast particularly well, however income that is the dominant driver of long term performance. Over the past 35 years, income has provided two-thirds of total returns with far lower volatility, as shown in the table.

<table>
<thead>
<tr>
<th></th>
<th>1981 to 2015</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Return</td>
<td>6.0% pa</td>
<td>1.0</td>
</tr>
<tr>
<td>Capital Growth</td>
<td>3.2% pa</td>
<td>9.4</td>
</tr>
</tbody>
</table>

COMPARISON OF TOTAL RETURNS 1981 – 2015

Source: MSCI

1- For a detailed statistical review of forecasting accuracy please see IPF: Reassessing the Accuracy of UK Commercial Property Forecasts (2011-2015).
The Global Financial Crisis

There was an insatiable appetite for getting into real estate.

It has been 8 years since the 26% decline in all property capital values in 2008, (on top of a 7% decline in 2007 and followed by another 4% decline in 2009) as the world was plunged into a global financial crisis and credit crunch.

The UK valuation industry recognised this by quickly marking property valuations to market (faster than any other market), and by supporting liquidity at a time when many other European markets became inactive. The impact was widespread and the listed real estate sector also reacted aggressively:

Well, 2005-09 was predominately a debt-fuelled market in terms of investment activity... and there were no barriers to entry, so anybody could go and buy and sell buildings.

Despite this, there was also a perception by many respondents that the crisis was something over which they had no control.

The crisis was considered to be ‘bigger than real estate’ and that there was very little investors or developers could have done to prevent the crash.

I think it was, it was bigger than property, and I think that investors could have done very little.

We asked our interviewees to what extent the property industry contributed to the cycle; investors suggested it was driven by essentially three factors:

- Excessive availability and use of debt,
- High risk behaviours and style drift in an attempt to achieve higher returns,
- An extremely unpredictable event.

The Listed UK Real Estate Index (EPRA UK) suffered an 82% peak-to-trough correction from early 2007 to Q1 2009. Significantly, the equity market anticipated the turning points in UK capital values around 6 months ahead of it showing in IPD monthly data. The extent of the correction in share prices was amplified by almost all companies being over-leveraged and therefore forced into dilutive rights issues and/or disposals of prize assets to shore up their balance sheets. Having traded at a 12% premium to NAV in early 2007 on euphoria surrounding the birth of UK REITs, valuations only bottomed out at a 47% discount to trough NAV in 2009.

However, the direct market did not predict the crisis. The IPF Consensus view, in (August) 2007 forecast a mild down cycle for 2008 with a decline in values of -0.4%. But could the impact of the eventual crisis have been mitigated?
While this is true to some extent – after all, what we experienced was a global financial crisis and credit crunch – the combination of inadequate risk management, style drift (riskier behaviour in an attempt to achieve higher returns), high levels of debt and the premise that capital growth will simply continue (for another year at least) were phenomena that were under the industry’s control. These factors clearly amplified the impacts of the downturn for specific individual investors.

As we will discuss later, senior figures in the industry believe that the experience of the previous cycle has resulted in many lessons being learnt as well as instigating a degree of behavioural change.

So what could have been done?

The down cycle of 2007 to 2009 was the most extreme experienced during the past 35 years and had followed a period of 11 years of positive capital growth. Whilst within this period we did experience cycles, we did not experience such an enormous correction from positive 13% growth in 2006 to -26% in 2008. Falling values created a huge buying opportunity for many investors who believed the long term value of UK real estate was significantly higher than the current market valuation. This paved the way for new overseas capital to enter the market at a lower basis, but seeking to mitigate further falls by focussing on long-let office properties in prime central locations, the well- documented flight to safety.

The following section will discuss the extent to which the industry had learnt lessons from this cycle and changed behaviours.
THE PRESENT

A NEW ‘NORMAL’
The industry may have learnt lessons from the financial crisis but have behaviours actually changed enough to mitigate the impact of future events? And is the industry better insulated as a result? There was an appreciation in our survey that whilst some behavioural change had already occurred in the industry, we were still adapting to structural changes that are challenging perceived norms. As such, established sector weights were already coming under pressure before the crisis with stock selection and future tenant demand becoming more critical.

We found a general consensus that a more strategic focus on specific locations and sectors had made investors more resilient than in the last cycle, with many claiming they were increasing their exposure to lower risk investments (and hence accepting lower returns) than they had pre 2008. Periods of extreme economic decline often play to the strengths of real assets, especially real estate as it offers both long term capital growth and a contracted income stream. However, the relative attractiveness of the asset class may erode for certain investors as bond pricing moves in line with inflation, but for many, fixed income is not necessarily the real opportunity cost of holding real estate as it also offers diversification in a multi-asset/global portfolio.

The flight to safety post 2008 has seen a greater focus on ‘longer-term’ investments, with an underlying acceptance that investments can take longer to generate returns and may not benefit from continuous year on year capital appreciation. Some investors are building insulation from future shocks by diversifying their portfolios differently, focussing on lower risk income (stronger covenants) in more resilient sectors and locations.

Although for example, the emergence of the logistics sector and its capacity to support the ‘new’ retailing supply chain offers the income profiles sought by overseas investors, with strong covenants and long leases.

In the context of a rapidly changing world, previously resilient sectors will not necessarily be the resilient sectors of the future; on the contrary they may be the most risky.
LESSONS LEARNT: INVESTORS BELIEVE THEY ARE BETTER PREPARED THAN IN 2007

INTERVIEWEES SAID...

RISK MANAGEMENT AND DATA ANALYSIS
“Professional investors have become more sophisticated, so risk management is better and strategic analysis is better. The way that businesses are run and capital allocation decisions are made have improved.”

LESS USE OF DEBT
“There has been less use of debt than there was in the 2004/5/6 period.”

MORE SCENARIO MODELLING
“I think people have realised that you need to do more scenario modelling – what if we saw another 40 or 50% crash in values, what would that do to your deal? People have become much more conservative.”

MITIGATING RISK BY ACQUIRING LESS
“I’m much more careful with acquisitions now and I will probably be acquiring less because of the Brexit vote, simply because the business is more than OK without anything new we won’t put ourselves under too much risk.”

HOW TO LOOK AFTER INVESTORS (AS A FUND)
“There were some critical lessons learned about how to look after investors and how not to do it… there has been a refocusing which is quite healthy.”

VERIFYING QUALITY OF TENANTS
 “[A] lesson people learned was, in that environment where the economy is in crisis, you pay much more attention to the current lease, how long have you got left on your lease, what’s the quality of your tenants, what’s their financial strength? I think people now pay more attention to...how that matches your debts and your refinancing schedule.”
The concept of ‘long term investments’ can be defined in many ways and some respondents emphasised the long term nature of capital invested.

Therefore the focus of long term capital is often on assets that support long term structural, and demographic demand in the UK, and this isn’t exclusive to the office sector.

Some sectors (and locations) have higher betas than others; they exhibit greater volatility. A general theme emerged from our research that sectors more closely aligned with demographic change and lifestyle would offer greater resilience over the long term.

Steven Cooper, Joint Head of Residential Agency BNP Paribas Real Estate UK

We expect there to be a continued widening of the supply and demand imbalance that will delay or prohibit owner occupation for many, particularly in London and core South East towns. These affordability pressures will force a change of mind set toward the PRS, although homeownership is still expected to remain the goal for most. While we see the PRS as a relatively mature sector in London there remain challenges in delivering product in other locations. The drivers of success go beyond the provision of an apartment in the right location; occupiers also consider the provision of technology, scheme design and layout, specification and operational management to be critically important. If the developer gets this right, it will help minimise the gross to net leakage and maximise occupancy.

This is true of residential, including PRS, student housing and to some extent care homes, hotels and leisure assets.
The retail sector continues to undergo major change and we feel the high retail weighting in the MSCI Universe is unsustainable over the long term, as allocations in excess of 40% come under pressure from ‘other’ sectors including distribution warehouses, residential, hotels and leisure. The graphic below shows the changing nature of portfolio weights in the MSCI Universe over the past 35 years, standard office weights reducing in favour of retail warehouse, logistics and ‘alternative’ sectors. This however can be misleading as the holdings of many global investors are not captured by the benchmark hence under estimating the true exposure to Central London offices.

<table>
<thead>
<tr>
<th></th>
<th>Standard Shop</th>
<th>Shopping Centres</th>
<th>Retail Warehouse</th>
<th>Supermarket</th>
<th>Standard Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>14.7%</td>
<td>9.0%</td>
<td>0.6%</td>
<td>0.7%</td>
<td>54.1%</td>
</tr>
<tr>
<td>1981</td>
<td>13.0%</td>
<td>13.3%</td>
<td>3.5%</td>
<td></td>
<td>25.5%</td>
</tr>
<tr>
<td>2015</td>
<td>9.8%</td>
<td>13.0%</td>
<td>0.6%</td>
<td>0.7%</td>
<td>14.5%</td>
</tr>
<tr>
<td>2015</td>
<td>11.7%</td>
<td>3.5%</td>
<td>0.9%</td>
<td></td>
<td>2.3%</td>
</tr>
</tbody>
</table>

Source: MSCI
With new technology comes fast-paced change. This has both benefitted and caused pain to the retail sector. Those brands and businesses that have adapted quickly to embrace digital and ecommerce platforms have moved ahead of the competition and diversified their offer with degrees of success. Amazon is now the largest retailer in the US. 3PLs and logistics property have flourished as investors switch the bias in their portfolios from core retail, which historically was the largest overall fund weighting, to logistics.

However, retailers are rethinking their online strategy and embracing physical shops as their biggest assets, through which they can showcase their brand. Successful retailers are now merging their online and High Street presence to provide a seamless customer experience across the web and in-store, which purely online businesses cannot match.

Furthermore, the retail innovations seen in the world’s leading transport hubs give a taste of what global brands have in store for us in the coming years, and show that a pure play ecommerce approach is dead, which is good news for real estate. Outside of these niches, much high street and retail property has suffered.

Where retail has lost traction with investors and occupiers, we are seeing leisure, and in particular, food and beverage, picking up the mantle. Research shows that having the right operator or rooftop bar while pre-letting an office scheme is a real attraction to occupiers, who are desperate to find the best space in order to attract and retain talent.

The best agents will be the ones to spot these trends early and advise their developer clients more strategically.
Risk management

The strong performance of the market in the years preceding 2008 led many managers (especially those of relatively core products) to move up the risk curve in order to achieve their target returns. In doing so they became exposed to elevated levels of risk that, in the case of many investors, they did not expect to be exposed to. Furthermore, the skill sets required to effectively execute a value add, opportunistic or development strategy are very different to those required to execute a core investment strategy. Fund-level definitions of fund strategy commonly used by the industry often mask the true risk within portfolios at an asset level.

Our respondents told us that investors’ default setting was now more ‘risk off’.

There is no doubt that risk is a much greater consideration in this cycle. For many investors this has meant a flight to quality and secure long-term income.

There are questions over what this attitude to risk will mean for the future built environment. The willingness of investors to take on the largest, long-term and most transformational projects like King’s Cross, opens up new markets and plays an indispensable role in regenerating our towns and cities. The number of investors who have the capital and appetite for these schemes is dwindling, but the industry needs such leaders and entrepreneurial spirit to keep moving forwards and to continue to place-make.

Simon Williams, Head of Investment
BNP Paribas Real Estate UK

LOWERS RISK INVESTMENTS

“There from 2009 we’ve invested significantly in income producing property with enhancement potential rather than risky properties which was harder to underwrite.”

LONG-TERM INVESTMENTS, AND ACCEPTANCE OF PRICE FLUCTUATIONS

“We don’t really have any major risk factors and also our income fund clients are all UK institutional investors who have, in my experience, a fairly traditional medium to long term view of asset classes. Therefore, they understand that prices go down as well as up in all asset classes and therefore understand that property provides a strong anti-correlation to their other asset classes.

REDUCED SPECULATIVE BUILDING

“We’re far more ‘methodical’ or ‘risk averse’ in terms of the buildings that we build speculatively and where we build them and the number that we put into the market at any one time – and I don’t think we’ll ever get back to a stage where we might have 20 or so vacant buildings under construction at the same time or available on the market. We’re undertaking a specific program now and in a much more measured way and in much smaller numbers so that if there is a big market crash then you’re not massively exposed to the loss of that product.”
Real estate lending and governance

The industry’s use of debt has changed substantially with investors generally carrying lower levels of debt than they were in the previous cycle.

The chart shows that in the lead up to 2008, lending to property had risen to in excess of 80% on average, but started to decline as the subprime crisis in the US emerged in 2007. At these levels of LTV there was not much of a margin to absorb capital declines before covenants were breached and certainly not the declines that were witnessed. Today we see a very different landscape, with the equivalent ratios at circa 65% across a far broader range of lenders.

Change has been driven from both within and outside the industry. Self-regulatory practises and tighter internal governance is now widespread through tighter investment committee procedures and decision making, the involvement of Compliance functions and a greater alignment of interests between managers and investors. Given the increase in focus on income during periods of uncertainty it is unsurprising that the industry now pays far greater attention to the events that might impact income streams on the downside, including the likelihood and impact of lease events and tenant default.

AVERAGE LTV RATIOS FOR DIFFERENT SECTORS 1999 – 2015

Source: DeMontfort University, Commercial Property Lending Report
THE PRESENT – A NEW ‘NORMAL’

THEY CARRY LOWER LEVERAGE & WIDER/SMALLER PORTFOLIOS

INTERVIEWEES SAID...

**STRATEGY TEAMS NOW IN PLACE**
“We’ve got a whole strategy team now, which we didn’t have five years ago, that look at risks on a whole different menu – so we take reports from IPD, from research houses, agents, investment banks, all sorts.”

**LESS INVESTMENTS IN FUNDS – PREFERENCE FOR JOINT VENTURES**
“Everyone wants to concentrate down on a smaller number of assets. Everyone goes to safety and they don’t do leverage, they do safer investments. They go right off the idea of funds. People who can afford to, who’ve got big enough wads of money say they want to do joint ventures. So, the fashion has been for the sovereign wealth funds...to find big, local players.”

**CARRYING LOWER LEVERAGE**
“It’s fundamentally changed how businesses are run. Our business is the quoted sector, and if you look at us and our peer groups, we carry lower leverage, our strategies are more focused and our operating platforms are more robust.”

**FEWER DEALS – FOCUSING ON SMALLER PORTFOLIO**
“There are probably fewer deals done generally now because, yeah, I think everyone looks at things that little bit harder.”
Changes to external regulation have also directly impacted real estate and real estate lending, particularly in relation to Basel III and Solvency II but also the German open ended fund business, a major source of liquidity to UK real estate. Solvency II governs insurance companies and the capital reserves they are required to hold against direct real estate.

This is deemed more risky than bonds and equities. While Basel III aims to ensure that sufficient capital reserves are held against real estate loans to protect the banking system against over exposure to commercial real estate.

The result has been that many traditional bank lenders have retrenched from real estate lending or limited their exposure to their own national markets, the gap then being filled by debt funds, insurance companies and other providers of funding.

As we can see in the graphic, the marketplace is far more diversified than it was in 2007 and future regulation may still impact this further.

Source: DeMontfort University, Property Lending Report
The challenge is that for real estate to survive it’s all about income maintenance, how do you maintain and grow your income? Occupier requirements are changing so much, which changes how you have to look at real estate.

Changes due to technology

Technological change impacts every business in every industry and hence has a direct impact on the occupation of real estate as well as the entire design-and-build process. From manufacturing to financial services, technology is not just the great enabler but is also the medium through which established cost structures are challenged and the competitive landscape is changed, and with it, the demand for real estate.

The profile of Central London occupiers has seen a dramatic change over the last 10 years, with media tech business taking an increasing amount of space, particularly in locations such as Southbank, Soho and the City fringes. Financial services remain a key part of the market, but London is not as reliant on them as it once was. With technology evolving so quickly, real estate needs to evolve too to match the changing and growing requirements of an increasingly important sector.

The enabling nature of technology and the impact of the internet have been seen most clearly in the retail sector, impacting demand for high street real estate but increasing demand for logistics space to support the supply chain network and the fulfilment of online sales. The physical store now performs a different role in consumers’ interactions with brands and are increasingly supported by an excellent online presence. The result is smaller more, focussed retailer portfolios.

While this may be true for traditional businesses, it also drives a need for space by businesses in emerging sectors such as media tech and fin tech. As such, occupational demand is now more diverse, no longer dominated by financial and business services.

Dan Bayley, Central London Office Agency
BNP Paribas Real Estate UK

Technology makes [manufacturing] easier to do. Ultimately, technology is simply equating to you need less space to do what you did previously.

We’re obviously aware of changes in the retail environment, in competition from other forms of retailing, so retail isn’t the dominant sector that it once was. It used to be the bedrock in commercial portfolios.
Demographic trends change very slowly and are driven by only three factors – the birth rate, the mortality rate and net migration. Whilst it is difficult to effect change quickly in any of these (although migration is currently a highly topical and political subject), we can look at the demographic structure of the UK today and make inferences as to the future demographic. We can therefore be quite confident what the UK will look like in 10 years’ time, and therefore how demand for certain types of real estate might be impacted.

In general it is clear we are living longer, and need to factor this into how we think about future demand. Over the next 10 years we are likely to see increasing demand for family leisure and primary and secondary education facilities as the number of people aged 10 to 19 increases, by 12%. Shortly afterwards this will translate into increased demand for education, although what this means for student housing depends largely on the outcome for overseas demand. According to recent data from HESA, 24% of UK students come from overseas, 72% of which came from outside of the EU. Since 2007, the number of foreign students has grown by 38% reflecting increasing global demand for the UK’s world-class education facilities.

Demographic change

As demographics change then so does demand for places to live, work and play. Organisations are constantly re-orientating their businesses based on demographic trends, both in terms of demand for their outputs, but also their workforce, considering what the next generation needs and expects from their place of work.

There’s a greater emphasis and shift on health and wellbeing. So the likes of a gymnasium as well as some catering, and catering for people’s who are quite busy in their day, so they won’t necessarily cook at home from Monday to Friday. Or they may need a crèche.

Change in UK population of five year cohorts 2016 – 2025
Nevertheless, the Home Secretary has recently stated that the Home Office is considering cutting international student numbers in an attempt to control net migration. The extent to which government migration targets will include or exclude students is yet to be seen but should be closely watched as this will impact demand.

The largest increase in demand will be for real estate geared towards those of retirement age. However we must be mindful that the retirement age can also increase and that an older workforce will likely demand a different workplace to that of a younger workforce. The number of people of retirement age is set to increase by 13% by 2025. This means retirement villages, retail and leisure focused on this age group, and care homes and related medical facilities are set see increases in demand.

Sustainability

Sustainability and CSR continue to increase in importance to occupiers, as does the importance of responsible investment for investment managers:

For most occupiers real estate is an integral factor in the production of goods and services and as such represents a significant cost to most businesses. The total cost of occupation is not limited to rent and business rates obligations but also the running costs of the building and these are directly related to its efficiency.

Furthermore, occupiers are also cognisant of the softer costs of real estate occupation including the ability to attract and retain the right talent as well as the reputational issues relating to the occupation of an energy efficient and sustainable building versus older, less efficient accommodation. In assessing the true costs of occupation it is therefore important to give due weight to both quantitative and qualitative factors.

Mismatched expectations?

Understanding the drivers of change in the occupational marketplace is critical to the adequate underwriting of real estate as an investment. Sustainable long term income will be dictated by the demands of occupiers, who increasingly view real estate through a different lens.

The overriding theme from our research was a need for flexibility due to uncertainty and structural change in many business sectors. This is driving an increased demand for flexible leases, higher frequency break clauses and more accommodating incentive packages. Landlords have responded, but tend to prefer greater certainty of income and fewer events that might interrupt cashflow.

So, while investors are seeking to future-proof their portfolios by seeking longer term income commitments, occupiers are demanding greater flexibility in terms of their operational lease commitments, enabling them to react quickly to change.

In the commercial world, it’s a factor of demand and supply. Investors are becoming savvier and more conscious about sustainability and therefore demand a certain product. It’s the responsibility of anybody holding commercial real estate to make sure that they’ve addressed the issue.
At this point, occupiers have a powerful position as they have moved ahead and embraced change. Traditionally, occupiers and investors have been polar opposites but never has this been so apparent. With the changing world, the gap becomes larger.

Occupiers creating demand and investors providing supply – the latest trends in real estate show this approach to be too simplistic. Demand is affected by many factors as diverse as technology, the ability to attract talent to your brand, and business and lifestyle trends. With occupiers embracing these attributes and investors being slower to adapt, it is the investors who move first that will take advantage.

Volatility is here to stay and if occupiers don’t like the space on offer they will vote with their feet. They will no longer make do with second best where top talent is available, for the rest of their estate they want flexibility, functionality and cost effectiveness.

Occupiers are beginning to understand the need to provide workplace environments that support their employees working lifestyles: one size does not fit all.

Portfolios need to be flexible at a macro and micro level – grow and contract to meet changing headcount requirements but also offer flexible workspaces offering a range of working environments. Offices meet leisure. Property management meet corporate solutions. Planners meet occupiers. The typical property lifecycle has changed and everyone has a say from the beginning.

We understand that and can bring the different parts together.

As the real estate adviser for a changing world, that advises both landlords and tenants, we can help bridge this gap.
THE FUTURE

WILL THIS CYCLE BE DIFFERENT?
In summary, yes, but cycles have always been driven by different factors. Our work with Ipsos MORI has demonstrated that the industry believes that this property cycle will be driven by an unprecedented and unique set of factors. If the previous cycle can be characterised as being driven by the vulnerability of the financial system, this one will be driven by political risk. However there are also other factors at play that will likely impact the next real estate cycle, and most are extremely difficult to model:

• The impact of quantitative easing and the persistent low interest rate environment changing our perception of what is the ‘new’ normal,
• Changing occupier requirements that impact upon the income generating ability of the asset class,
• The availability, structure and cost of debt,
• Exchange rates and capital flows.

If we accept this, we also accept that using traditional forecasting processes that are anchored by historical relationships are less relevant in today’s rapidly changing world.

WILL THIS CYCLE BE DIFFERENT?

Everyone thinks everything is wonderful, until something happens that reminds them that actually it’s not wonderful... it’s like the coyote going off a cliff [in the cartoon Road Runner], and for a while it keeps on running before it looks down and then it plummets. That’s why while humans are involved in the marketplace you’re going to have cycles.
The biggest problem is not new; it is the continuing escalation of debt by ALL western countries. I really don’t think that we are in a global world of austerity; we are coming out of 40 years of decadence. Our standards of living are only high because all countries are borrowing so much. That is the bubble that will burst soon and that will lead to a global depression. We are walking a tightrope. Brexit and Trump are just chairs on the Titanic.

The consensus of those interviewed by Ipsos MORI was that this cycle would be **shorter, bumpier and driven by political events**. In fact, the view was that future property cycles may be shorter and bumpier, rather than the established cycles of the past, seven to 10 years long with pronounced peaks and troughs.

It has been a political cycle very much back to the last crash. There was a political decision then to move the debt balance sheet from the private sector to the public sector, and to avoid the banks going bust. Then we had interest rate policy and quantitative easing. This has extended out the business cycle.

Should another global economic malaise occur, respondents felt real estate, particularly in London, would remain attractive versus other asset classes.
The Greeks for example, so much money came in to the UK when their economy crashed. Likewise Russian money came over because of this flight to safety. We’re talking about commercial but on the residential side as well, simply because of this weight of money coming in to the UK.

Our respondents believed Brexit would not have a dramatic effect, despite the real risks to the financial sector in Central London. The combination of lessons learnt and behavioural change contributed to a relatively optimistic view of the future with a softer landing and less dramatic corrections than in previous cycles. This translated into a general sense of calm, or at least a ‘wait and see’ approach, in respect of Brexit. Unsurprisingly the liquid REITS market did react negatively to the news as sentiment can be instantly reflected in the marketplace; however the future evolution of the market remains positive as the market continues to evolve.

However, the UK’s status as a safe haven for global investors was also thought to cushion the negative impacts of political events in other countries.

There has been too much of a tendency to see Brexit as a British thing, a British problem, but it is not. The bigger complication is for continental Europe. The fallout from Brexit is two way; us and Europe.

Generally speaking we actually have the best lawyers here, we have the best real estate professionals, we have the best finance professionals and everything’s done above board.

The tax efficiency of the REIT structure and its flexibility relative to open-ended funds suggest the sector will continue to grow over the long-term. There is room for growth in sector-specialist REITS in the UK, particularly in non-traditional asset classes such as healthcare, hotels and student accommodation. Residential REITS are another obvious growth area, particularly considering the scale of the listed residential sector in Germany. Greater institutional investment in the build-to-rent sector could pave the way for future IPOs. There is also the likelihood of consolidation of some smaller REITS in the medium-term to drive cost efficiencies, while offering investors access to larger, more liquid vehicles.

Source: Exane BNP Paribas, Datastream, Company reports, EPRA.
THEY CARRY LOWER LEVERAGE & WIDER/SMALLER PORTFOLIOS

INTERVIEWEES SAID...

A STEEP DROP IN CAPITAL GROWTH IS NOT EXPECTED AND THE DEVALUATION OF THE CURRENCY IS THOUGHT TO ENCOURAGE FOREIGN INVESTMENT

“The currency adjustment will allow overseas buyers, long term buyers, to arguably come in and acquire at a discount, and I see that propping up the market and helping the market, and arguably cancelling out the fact that I’m choosing to pause. So instead of seeing a drop or a dip I just see it flat, not much will happen and it will remain flat, and that’s my view.”

IT WAS CONSIDERED THAT BREXIT WAS SPEEDING UP A CORRECTION THAT WAS ALREADY NEEDED

“Whether or not we’d had the subprime crisis and the banks falling over there would have been a correction in the market just as there has been as a result of Brexit. The market was in need of a correction last year/this year and Brexit will help facilitate and speed up that value correction.”

AND THAT THE WARY INVESTORS WILL CHANGE THEIR MIND AND INVEST ONCE MORE

“I know Europeans who say that we’re not going to touch UK, and that’s a kneejerk reaction – that’s a sentiment driven concern – but I think it relates to the uncertainty around what happens next.”
The US election result was thought to be less important than the potential fall-out from Brexit, and should not necessarily be seen as negative. In the US, real estate is well placed to benefit from a possible surge in infrastructure expenditure.

**US real estate has always been driven by indigenous investment. If Trump does decide upon a massive re-investment in infrastructure country wide, this could trigger a boom in the real estate markets.**

**It is too early to say. It all depends on what his policies mean in practice.**

**What does this mean for market performance?**

Those interviewed were asked to predict UK capital value growth for the next five years. We were not looking for formal house view forecasts; rather to understand how respondents felt the market would evolve. What we found was a high degree of variation and an acceptance by many that this was an incredibly challenging and uncertain environment unlike any other (some even asked if they could ‘do their forecasts in pencil’).

Interestingly, although opinions differ dramatically, this method of tracking produces a trajectory that is similar to, but slightly more optimistic than, BNP Paribas Real Estate’s current five-year forecast, with a bottoming out in 2017/2018 before returning to positive growth.

Source: BNP Paribas Real Estate Cycology, MSCI
**How will we see future shocks coming in the future? Are we more prepared?**

Respondents felt that the shocks of 2008 were unlikely to be repeated and that the industry had learned many lessons as a result.

They certainly felt more prepared to deal with another major shock and believe both they and the wider financial system are more resilient. Changes to regulation have helped to ensure that the banking system is better capitalised so as not to amplify another major shock.

**Lead indicators and fundamentals**

The ‘fundamentals’ that drive the cycle –supply and demand– are universally recognised but it was felt that understanding future cycles was more complicated than this, headline supply and demand mask this complexity.

Our interviewees felt that they were better placed to identify early indicators of future bubbles and now track a wider range of leading indicators including:

- Being heavily outbid (a sign that the market is overheating)
- Development rates
- Increased supply of investment opportunities
- Credit cycle changes

Credit bubbles often precede real estate bubbles, so if the banks are disciplined, things are less likely to get out of hand.

- Absolute yield levels
- Long-term risk free rate
- Income stability

I think the absolute level of yield is important, as is the yield against risk free rates. That’s where the challenge is now, because risk free rates are so low and negative. I look at the long term risk free rate rather than the current risk free rate, and so the spread between yields and the risk free rate is another important leading indicator.

[If] we’re being significantly outbid we will assume that people are applying unrealistic assumptions to property assets. For me, that’s the biggest sign that the market is getting a beating.
FUTURE RISKS

When looking at future risks, interviewees considered some of the ‘new fundamentals’ as potential risks to future real estate performance, including technology, sustainability, globalisation and politics. Our interviewees identified other factors that contributed to the 2008 crash – over leverage, secondary locations with poor liquidity, and over reliance on too few lenders were deemed the most concerning.

There was also a worry over the psychology and collective memory of investors:

That’s the behavioural aspect that you’ll never get rid of... people see that something worked previously, forget that it actually failed, and then carry on again.

- That others will make the same mistakes again, due to a collective fading of memory,
- And concerns that the next generation of investors and developers are insufficiently in touch with the past.

THE RISK POINTS: LESSONS NOT LEARNED

INTERVIEWEES SAID...

NEXT GENERATION INVESTMENT

“It’s possibly a generational thing. Successive generations of people haven’t learnt the things that the people who have been doing it for a few years have learnt the hard way, and so there’s a loss of corporate memory over time. People are destined to repeat the mistakes of previous generations, and people going through the same sorts of problems. But I think the problem is each crisis that comes, each shock is a bit different from the one before.”

INVESTING IN SECONDARY LOCATIONS WITH POOR LIQUIDITY

“So in the downturn people said, ‘oh never again am I going to go to secondary locations... We’re only going to invest in the biggest locations and asset classes.’ And now what you’re seeing is everyone saying, oh London is expensive, or New York’s expensive, let’s go to a secondary location. Let’s go into these alternative property types because you can’t get the yield on the core, which is what people said we’d never do again.”

OVER-BORROWING

I think what’s going to drive people is going to be availability of debt which is very upsetting because all the things that happened in 2006 to 2008 were 100% driven by lack of regulation and too much debt. We’re just going to repeat what we’ve done before.”

OVER DEPENDENCE ON SOME SOURCES OF CAPITAL

“There’s still an element of surprise, people are surprised by some things which happen. There are people who are not surprised, but again it’s sort of, it’s the over dependence in some cases on certain sources of capital.”

LESS RELEVANT TO THE NEW GENERATION

“If you haven’t properly experienced [a crisis] as a reference point, it’s perhaps less understood and relevant. Then there will be a new generation of lenders and investors who do not regard the world as having changed...”
LONDON THE GLOBAL CITY

Despite everything that I said about caution through Brexit, London has many, many other attributes that will make it a very sustainable investment location.

I think people like to be here, I think they are made pretty welcome here, I think it’s a great culture, London; it has the theatre, it has general entertainment, it has an abundance of restaurants and hotels and I think it, it’s a great place for people to be.

Those interviewed told us that whilst the UK, especially London, is perceived as a safe haven and almost ‘too big’ to fail it still faces a range of challenges.

However, the UK’s political stability, strong judicial system, high liquidity and transparency make it a critical component in a global investment portfolio.

London is not just a global real estate market but also, for the first time, the highest ranked global city for business performance in AT Kearney Management Consultant’s Global Cities Index.

London and New York are the only two cities that appear in the top 10 of both current performance (see ranking below) and the outlook for future performance.

GLOBAL CITIES INDEX, 2016 RANKING

1 LONDON  2 NEW YORK  3 PARIS  4 TOKYO  5 HONG KONG
6 LOS ANGELES  7 CHICAGO  8 SINGAPORE  9 BEIJING  10 WASHINGTON DC

Source: AT Kearney Management Consultant Global Cities Index
The AT Kearney report notes that London led New York in ‘cultural exchange’ and ‘business activity’, closed the gap in terms of ‘human capital’ and had also seen noticeable improvement in ‘information exchange’. While New York’s political engagement has dropped 10%, London’s has increased 33%.

London’s dominant position is illustrated by the real estate performance of Central London offices versus other regional UK markets. Whilst value growth in both Central London and regional markets started to decline some time before the EU referendum, Central London had already experienced growth since 2010 not seen in other markets, and hence was declining from a much higher base.

Despite being the most volatile market in the UK, there seems to be an acceptance that the global nature of London is a key driver behind its safe-haven status. Risk-adjusted returns allow us to compare historic volatility and risk, and on this metric London offers lower risk adjusted returns than other less volatile markets.

However, we believe that today’s structural changes necessitate a forward-looking view of markets rather than focussing on historical analysis. Increasing globalisation and the global nature of capital seeking real estate exposure means London will likely increase its importance as a global destination for business despite the short term political challenges.

Dan Bayley, Central London Office Agency
BNP Paribas Real Estate UK

London is a major driver of UK performance and has proven itself to be extraordinarily resilient. London’s attraction is built on an extraordinary mixture of business, culture and history, with world-leading credentials in technology, creative industries and finance.

We have, pretty much the most transparent market in the world.
CONCLUSION
CONCLUSION

The insights gathered from our research - from real estate, business and academia - give a clear message that investors are significantly better prepared for the next downturn and the potential fallout from Brexit and other external shocks than they were in 2007. This is as a result of lessons learnt, the adoption of new behaviours, and the impact of external regulation.

Debt remains a significant part of the real estate market. However, the market is more cautious than in 2007. It is also more diverse, in terms of its participants and the sectors in which they invest. We increasingly see defensive activities in counter cyclical sectors such as the PRS, leisure, prime retail, and logistics.

Dislocation, disruption and risk also represent opportunity, the skill is to correctly price that risk. Questions remain though over who, aside from a few notable investors, has the capital and appetite to commit to the 'transformational projects' of the future that are essential to renew the fabric of our built environment.

This cycle has also seen a growing divergence between investors and occupiers. Perhaps inevitably, given that they drive demand for space, occupiers are a step ahead and are quickly embracing demographic and technological change. Shorter leases, flexible working, sustainable buildings and the impact of technology are becoming critical components of business success, but have not yet been fully embraced by the entire industry.

These findings highlight the need for all involved in real estate, be they developers, investors or occupiers, to evolve their forecasting methods and to seek out the expert advice that will allow them to navigate the way ahead, and to bridge the gap between the old world and the new.

The cynics will always say that when the good times come back people forget those lessons. I think some of those lessons have been taken to heart, which I think is very helpful.
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