REAL ASSETS

Investor Thinking

JAN. 17

Strategic **Directions**

2017: SPOTLIGHT TURNS TO THE EURO AREA

- Political risks to remain throughout 2017
- Offices and logistics the preferred sectors, with development an opportunity in key cities
- Alternatives to act as portfolio diversifiers, with non-business cycle drivers

Believe it now you see it

Inflation is back and its return has revived investors' expectations for growth. In turn, bond yields and commodity prices have risen. However, these movements are *relative* to last year. AXA IM strongly believes that higher yields are here to stay, but we are moving into a period of normalisation rather than a step-change in our outlook. Moderate economic growth and heightened market volatility are likely to shape investor sentiment in 2017 – as they did in 2016.

Another factor that will not change in the next 12 months is the relevance of political risk, given the busy political calendar in Europe and the start of a new administration in the US. The political events in 2016 highlighted just how hard their outcomes are to predict. With that in mind, our investment strategy will largely focus on low-risk, core assets with a strong emphasis on international diversification at the portfolio level.

Getting used to rental growth in the Euro Area

Investors are right to feel cautious, but real estate's prospects for 2017 are positive. Take the Euro Area for example – prime office rental growth averaged 2.6% year-on-year in Q3 2016. With the slowing of yield declines, the acceleration of rental growth is timely. Moreover, it is a reminder that the Euro Area has made considerable progress since the end of its last recession in early 2013, even if each quarter since has underwhelmed.

An improving labour market has driven this quiet turnaround. The unemployment rate breached a psychological barrier by falling below 10% in October 2016.[1] That level of unemployment is not a signal that the recovery is complete; the Euro Area is only just getting back to a level where the US and UK began their recoveries over five years ago. However, importantly, there has been enough progress in the labour market to have a positive impact on office vacancy rates and, in turn, rental growth.

Figure 1 shows how office vacancy rates have mirrored the steady progress in the labour market. Average office vacancies are down to 8.2% – not far off the lows of 2008 – having fallen for the last 11 consecutive quarters. Vacancy rates within the Euro Area are diverse (from 6% in France to 14% in Spain),[2] much like

[1] Euro Area unemployment rate stood at 9.8% as at October 2016, Eurostat

[2] CBRE average office vacancy rates as at Q3 2016

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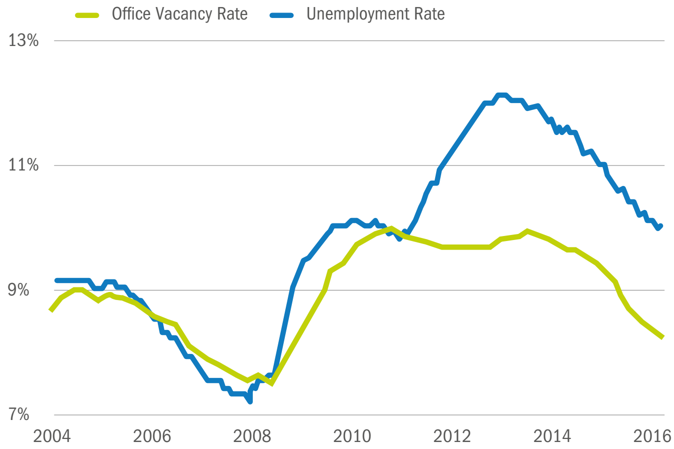
unemployment rates (from 6% in Germany to 19% in Spain and 23% in Greece).[3] Therefore, even though there is broad positive momentum across the region, a select group of locations have stronger occupier fundamentals, tight enough to generate the income growth investors seek.

Figure 1: Euro Area continues to improve



Source: Macrobond, CBRE (data as at December 2016)

Location is key

Generally, the CBDs of Europe's largest cities have the lowest vacancy rates in the region. The contrast is clearest in Spain, where the national vacancy rate stands at 19%, while wider Madrid's vacancy rate is 13% and the CBD is down to 9%. By viewing vacancies at increasingly granular levels, a similar pattern emerges in other major cities. CBD vacancies are below 4% in Paris, Munich and Milan and are much higher in peripheral areas.[4] While available space in CBD areas can be rare, available new space can be rarer still.

It is little surprise that prime locations are leading the improvements in headline rents, given their low levels of available space. Across Europe, our prime rental growth forecasts for 2017 are strongest for Barcelona (5%), Madrid (4%), Stockholm (3%) and Berlin (2%), with Paris and Munich not far behind.[5] Meanwhile, our outlook for average rental growth is more subdued, in line with the weaker occupier fundamentals.

Therefore, a focus on core real estate is a reflection of the relative strengths of prime assets and prime submarkets over second- or third-tier locations and a belief that with such investments, income growth has the ability to keep pace with, or even exceed, inflation.

The paradox of low-risk development

Not only tenants struggle to find prime space in Europe; investors also cite a lack of suitable product on the market for purchase.[6]

Global real estate volumes had been rising each year since 2009 until they peaked in 2015 at USD868bn. Investment volumes slipped to USD768bn over the 12 months to the end of the third quarter of 2016[7], and could drop to around USD600bn to USD650bn in 2017[8], but that would still represent a healthy level of liquidity. The appetite for assets in secondary locations is waning among potential buyers, considering the caution among investors at present and fewer prime assets coming to market, after heavy buying (and selling) in previous years.

The combination of strengthened occupier markets in Europe's CBDs and a lack of investible stock creates the opportunity to refurbish and improve offices that would have the potential to command a prime rent. The issue often cited with this strategy is the amount of risk involved outsizes a core investor's appetite. However, the capital expenditure in the short term is frontloading any inevitable capital expenditure required later in the hold period to counter depreciation. Leasing risk would also be high, but much like capital expenditure, the risk and cost is merely frontloading what an investor could experience later in the holding period at a time when conditions could be weaker.

Development, another step up the risk curve, would have the same rationale. Investors with a long-term strategy to maintain a stable exposure to Europe's key cities could consider a proportion of their capital for a develop-to-core strategy.

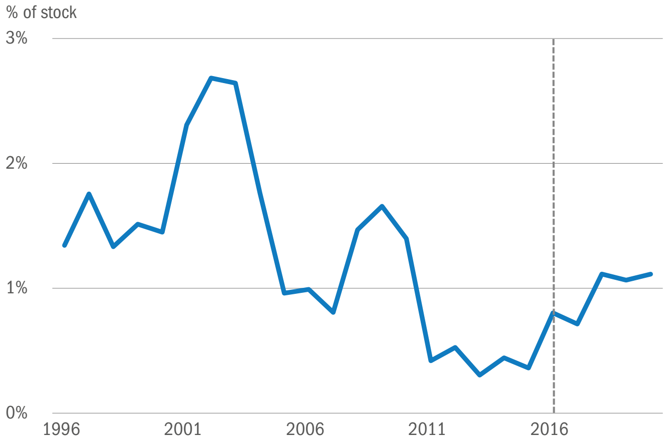
The main risk to any refurbishment or development is the pipeline of rival schemes. Figure 2 shows how net additions of office space remain low, despite the expected gradual rise in the coming years. To give further context, the lack of supply since the Great Financial Crisis has left Europe with an ageing stock. Over 50% of stock in London, Paris, Munich, Madrid and Stockholm is over 20 years old.[9] Tenant requirements

[3] All unemployment rates as at October 2016, Eurostat
[4] All vacancy rates quoted are as at Q3 2016, CBRE
[5] AXA IM – Real Assets' forecasts as at December 2016

[6] Emerging Trends in Real Estate Europe 2016, PwC/ULI
[7] RCA, as at January 2017 for all transaction volume data
[8] AXA IM – Real Assets estimate based on the rate of slowdown in transaction activity seen in 2016 continuing into 2017
[9] According to PMA estimates as at September 2016

have changed greatly over the last two decades and existing stock is often unsuitable for those needs. In that sense, development can reduce the risk of obsolescence and the associated risks with leasing and capital expenditure that comes with older buildings.

Figure 2: European* office net additions increasing but remain low



Source: PMA, AXA IM – Real Assets, forecasts as at April 2016 (LBY scenario)
* London, Paris, Germany (Big 6), Brussels, Luxumbourg, Milan & Madrid

Low-risk development seems like an oxymoron, especially at a time where investors are risk-adverse. However, those investors with a long-term view and a focus on key locations have an opportunity to adopt a measured approach to risk-taking at a portfolio level.

Logistics: the top sector for 2017

While there are opportunities in select parts of the office market across a range of risk profiles, logistics has more broad support for outperformance. We expect total returns for European logistics of around 7% each year in 2017-2019, producing outperformance of around 150-180bps versus other property types.

Logistics development is another area where a risk-on approach in the short term should put investors in a better position in the long term. Tenant demand should outstrip supply in the coming years, driven largely by third-party logistic operators (3PLs) and major retailers. Build-to-Suit is an entry point for investors, which makes sense given tenant appetite for modern space. This strategy is applicable to major markets such as the UK, France and Germany.

Alternative source of diversification

Although we focus on a short list of major cities and locations, we consider a wide range of potential property types. Diversification can come from investing in property types with non-business cycle drivers. For example, student housing has become an increasingly attractive property type in the sphere of operator-driven real estate investments. Structural growth in global student numbers, alongside low levels of purpose-built student housing have made student accommodation an interesting addition to more cyclical property asset classes. To date, student housing investors have benefitted from resilient revenue growth, with limited NOI downside, particularly during recessions. Global investor interest has continued to increase as yield spreads have supported the respective investment case. Focus has concentrated on the US and the UK — the most mature and liquid markets. Less institutionalised markets such as Germany and France, characterised by limited amounts of investable stock, should see further market maturation as the successful adaption of US and UK models bolster investor confidence.

Other alternatives, such as hotels, healthcare and, data centres each have their own long-term drivers of demand and offer a wide range of risk-return options. Regardless of a country's political calendar or short-term economic prospects, we are still likely to see growing tourist arrivals into Europe, still have ageing populations and still have a huge ramp up in data storage needs.

Alternative property types are niche, long-term investments but we view them as essential diversifiers in today's environment.

Outlook for 2017

The year ahead is likely to see a push for core real estate, as a number of political events unfold. The definition of core should extend to a wide range of property types, but be restricted to only the largest, most liquid locations. The end goal of the year is to secure diverse, high-quality income streams for the long term. For investors that already have a stabilised portfolio, or those willing to take on more risk while occupier fundamentals improve, European office and logistics markets offer a range of development and refurbishment options. In addition, alternative assets should provide exposure to long-term growth trends running counter to the wider economic cycle.

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