The Advancement of Real Estate as a Global Asset Class
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- Investors continue to look for yield in a low interest rate environment
- Global portfolios are rebalancing towards real estate
- Real estate investment flows are expected to tilt towards Asia Pacific

The global hunt for yield and capital protection

The Global Financial Crisis (GFC) has been a catalyst for fundamental change in global real estate markets and the post-GFC world of real estate that is now emerging differs sharply from the pre-2007 profile. The ranking of investor preferences between locations and sectors is now under review - capital growth ambitions that dictated many investment decisions pre-GFC have given way to a global hunt for secure income streams.

The trends that are appearing are both numerous and diverse - but most of them can be captured under two broad headings:

A. Global portfolios are rebalancing towards real estate

While real estate asset values have shown no immunity to the financial shocks of recent years, real estate is nevertheless coming forward as a preferred option for many investors. We estimate that the direct commercial real estate transactional market will exceed US$1 trillion per annum by 2030, compared with 2012 annual volumes of nearly US$450 billion.

Illustrating this trend:

- The Canadian Pension Plan Investment Board (CPPIB) increased its real estate allocation from 4.3% in March 2007 to 10.6% by September 2012;
- The National Pension Service of Korea (NPS) expects alternative investments to account for more than 10% of its total portfolio in 2016, compared with 2.5% in 2007; and
- In March 2010, the Government Pension Fund of Norway allowed for a maximum 5% allocation to real estate; it had previously been zero. The manager of the fund, Norges Bank Investment Management, has already spent US$3 billion on real estate and is targeting US$33 billion by 2020.

Given the large relative size of global bond and equity markets compared with the real estate investable universe, even a small weighting shift towards real estate could have profound implications for the sector. For example: a 1.0% down-weighting in equity markets in favour of investment in non-residential real estate equity implies a 7.8% rise in holdings in the real estate market. A 1.0% down-weighting in holdings of global bond markets in favour of real estate has a similar impact.

Thus, while capital availability remains constrained in some locations and for higher risk activities, such as development, the broader theme is that a growing pool of capital is emerging that seeks exposure to real estate of institutional quality. The numbers are potentially substantial - for example, a 1.2% reallocation of the funds of the 30 largest sovereign wealth funds towards real estate would increase capital allocation by US$50 billion, equivalent to the entire Sydney CBD office market.

Nor is this pool of capital solely directed to equity exposure. In the aftermath of the GFC, access to debt remains constrained in many sectors and locations, as traditional financiers have moved to limit or reduce their exposure to real estate. New capital sources and financial instruments are rapidly filling the vacuum and the cost of debt is declining sharply from its GFC peak.

What is driving this global portfolio tilt towards real estate?

Clearly a re-assessment of risk is one of the drivers. Investors seek risk reduction through diversification, and this implies a lessening of exposure to the traditional portfolio cornerstones of bonds and equities. But the over-riding driver is the global hunt for yield.

With sovereign bond market yields at multi-decade lows (and in some cases, multi-century), and with the outlook for capital growth subdued, yield has become a core driver of investment returns.
While real estate yields have tended to follow bond yields lower in many markets, the spread between real estate and sovereign debt yields remains high, offering generous compensation to investors for the additional risk associated with real estate. Across 11 major global markets, spreads between real bond rates and prime-grade office market yields are, on average, 195 basis points wider now than in Q4 2007.\(^3\)

**Figure 1: Yield Spreads between Prime Office Assets and Government Bonds, 2007 v 2012**

Source: Jones Lang LaSalle, 2013

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3 The exception is the Shanghai office market, where high inflation in 2007 brought government bond rates into negative territory making the gap between property returns wider than it might otherwise have been. Since 2007 two factors have reduced the gap: First, inflation is under control following active measures by the Chinese government to cool the economy. Secondly, the perceived risks of investing in property in China have diminished and the weight of capital has compressed prime office yields from close to 8% in Q4 2007 to around 6% today.
B. Real estate investment flows expected to tilt towards the Asia Pacific region

Cross-border capital flows are once again rising. While all regions are participating, there is a tilt of real estate investment flows towards emerging markets, and particularly the Asia Pacific region. While no region has been immune from the impact of the GFC, Asia Pacific is emerging as the long-term winner in the global contest for investment capital. Direct commercial real estate investment in 2012 was 77% of the 2007 peak value in the Asia Pacific region\(^4\) - the comparable figures for the Americas and Europe are 62% and 46%.

Figure 2: Direct Commercial Real Estate Volumes, 2007 v 2012

![Graph showing 2012 volumes as a proportion of 2007 volumes](image)

Favourable economic growth underlined by relatively strong recent GDP performance (2008 to 2012), at a time when North America and Europe have been battling recession, has emphasised the long-term attractions of the Asia Pacific region. Nevertheless, operational challenges, low levels of liquidity and, in some cases, undeveloped capital markets in the region remains a constraint on institutional investment, which partly explains why most Western institutions are underweighted in Asia Pacific relative to the size of its real estate markets.

Yet the long-term imperatives of economic growth, high rates of saving, rapid urbanisation, the inexorable rise of the middle classes and high levels of new construction, as well as evidence of improvements in transparency, all suggest that relative real estate portfolio weightings will move in favour of the Asia Pacific region in the future. Activity will also be boosted by the rise of domestic institutional capital (pension funds) and private wealth in the region– it now has over 45,000 ultra-high-net-worth individuals (UHNWI) with a combined wealth of US$6.7 trillion\(^5\).

Pramerica Real Estate Investors estimates suggest that while the U.S. and EMEA’s weightings to the global commercial real estate investable universe will decline, Asia Pacific’s is likely to rise sharply from 27% of the global total in 2011 to nearly 50% by 2031.

\(^4\) Asia Pacific excluding Japan would be 117%
\(^5\) World Ultra Wealth Report 2012-2013, Wealth-X
The new global real estate landscape

A. Investors targeting a limited number of ‘super-prime’ assets across 30-40 cities

One of the consequences of the GFC has been the polarisation within the real estate investment market between prime and secondary assets. Less obvious has been the division within the prime segment of the market, where we are starting to see a ‘super-prime’ sector emerging. Driven by a combination of economic adversity, a search for yield in a high liquidity environment and an increase in allocations by pension funds and institutional groups, a small number of buildings globally are being targeted by a growing volume of capital. These predominantly office and retail buildings across 30-40 cities (but concentrated in key gateway cities such as London, New York, Paris, Tokyo, Hong Kong and Sydney), are the best located, fully leased properties with the highest environmental credentials that are able to provide flexibility to corporate tenants.

Irrespective of whether this select group of buildings is on the market, institutional investors are targeting these assets as the type of product they want to own over the longer term. This appetite from well-capitalised groups, increasingly from emerging markets, has driven up the prices of these assets and compressed yields, in some instances below the levels recorded at the peak of the investment cycle in 2007.

In North American and European cities, this pool of super-prime properties will only grow slowly over the next five years, given the cyclical slowdown in asset creation in these regions. By contrast, Asia Pacific cities will account for an increasing proportion of this type of assets over the remainder of the decade.

B. Improving real estate transparency

The issue of real estate transparency will remain a permanent source of concern for investors, a subject brought into sharper focus as cross-border investors reach deeper into new locations and markets in search of yield. ‘Low transparency’ continues to be
a binding constraint in most emerging markets and, as a result, there are potentially huge pay-offs for those high-growth countries that can improve their regulatory environments and the transparency of transaction processes.

As the Jones Lang LaSalle 2012 Global Real Estate Transparency Index® shows, rising levels of transparency are associated with higher levels of direct commercial real estate investment. For example, while global investment volumes have grown by 48% between 2008-2009 and 2011-2012, for the 10 countries that have shown the greatest improvement in transparency, volumes have nearly tripled (+146%), which is twice the growth rate of other emerging markets (+74%). Two of the world’s fastest growing commercial real estate investment markets over the past couple of years - Turkey and Brazil – both feature in the 2012 Index as the top transparency improvers. Turkey is attracting strong investor interest, with increasing availability of market data and greater clarity in its transaction processes. Brazil, which has registered a nearly five-fold expansion in commercial investment activity since our previous Transparency survey in 2010, has seen its Tier 1 cities such as São Paulo moving from the ‘Semi-Transparent’ into the ‘Transparent’ category in the 2012 Survey. In Asia Pacific, Indonesia and Vietnam are beginning to see strengthening international real estate interest, both having made notable improvements in real estate transparency.

The demand for greater transparency is universal among institutional investors, and this will continue to drive improvements in transparency. Greater regulatory oversight of the investment process post GFC will also add weight to its importance. There is growing recognition by policy-makers in some emerging economies that the lack of performance measurement data, poor-quality market information and inconsistent application of property laws is hindering inward investment – this will act as a powerful incentive for further progress in transparency over the next few years.

C. Sale-and-leaseback activity boosts pool of investable stock

The demand for space by occupiers continues to grow fastest in Asia Pacific, with China and India being the top choices for portfolio expansion by firms from all three regions (see map overleaf). One issue for occupiers looking to expand in the developing countries of Asia Pacific is the stage of evolution of landlord and tenant markets. In many of the region’s cities, owner occupation rather than renting of space may be a more usual option for occupiers. Chinese corporates have often preferred owning to renting which reflects the history of state-owned enterprises owning their own premises. If corporate occupiers require property of a particular type or style, then developing new build or buying may be the way to access the type of facility they need. A similar story exists for public body occupiers in the region such as government departments. Over time, as capital markets in Asia Pacific mature these occupiers may be expected to direct scarce capital to core business activities. As a result, the same sale-and-leaseback process that is commonly seen in Europe and the U.S. could materialise. That, in turn, would provide a pool of stock for pension fund investors and similar funds to buy as the pool of savings grows. Asia Pacific (excluding Japan) is now witnessing a significant growth in sale-and-leaseback volumes, having risen by roughly 48% in 2012 compared to 2011. Within the region, the big area of sale-and-leaseback growth is in South Korea, where several deals have taken place involving companies such as Hyundai and HP. Nonetheless this is a global phenomenon with worldwide sale-and-leaseback activity rising by 18% in 2012, evidenced by Norges Bank Investment Management’s recent purchase of Credit Suisse’s headquarters in Zurich for US$1.1 billion.
D. Increasing pace of redevelopment of obsolete stock

Low interest rates will stimulate the redevelopment of obsolete stock across the commercial real estate sector through a number of avenues:

- Firstly, low interest rates reduce the investment hurdle rate, widening the class of projects that meets the hurdle criteria for viable development;
- Secondly, low interest rates extend the payback period, encouraging the development of projects with longer life cycles and even lower rents. This is consistent with the shift towards sustainable development that meets both policy aspirations and the regulatory requirements of a range of governments and major corporates;
- Thirdly, the sharp fall in construction activity (2008 to 2012) in many markets has created a backlog of demand for new buildings and an ageing asset stock;
- Fourthly, the growing yield gap between prime and secondary assets increases the potential rewards from repositioning, replacing and upgrading assets from secondary to prime, creating an incentive for refurbishment and redevelopment. The yield gap is likely to persist given the growing demand by institutional investors for prime-grade assets; and
- Finally, the recent wave of technological change will stimulate the replacement or redevelopment of existing assets, sometimes for alternative uses. For example, the rise of on-line shopping implies that existing retail infrastructures may not be optimally located, configured or fit for purpose. As a result, legacy issues

The key areas for growth over the next 3 years are largely emerging markets whose economic potential has grown exponentially in the recent past, such as the BRIC markets. Well established but more costly markets such as the United States and Europe are more likely to see a decline.

Source: Jones Lang LaSalle Global Corporate Real Estate Survey
will arise in established markets, although in many emerging markets (especially in Asia Pacific, Latin America and Africa) these issues will not occur to the same extent. Similarly, many office assets have not been designed for a wireless environment and the increased mobility and flexibility that modern IT usage implies. Similarly, industrial facilities are often not optimally located or designed for e-commerce or computerised inventory management.

The net result of these five drivers is that the life cycle of existing secondary grade assets is likely to be abbreviated. They will be replaced by modern assets built to higher and more sustainable specifications, which are attractive to the growing class of global real estate investment institutions. Nonetheless, fragmented ownership of assets through strata title will continue to act as a constraint on redeveloping poor-quality stock in many emerging markets.

E. New asset classes gain traction

The escalating levels of sophistication and development of real estate investment over recent years has led to sections of the market, which were once thought impossible to monetise and securitise, attracting a significant amount of interest and capital. Student housing, port facilities, roads, bridges, individual and multi-family residential complexes, vineyards and forestry are now proving popular with groups who also invest in traditional real estate.

The common factor with all these asset classes is the desire to hold income-producing assets even if they only provide modest capital growth over the long term. Institutional capital, such as pension and insurance companies, are particularly attracted to these categories of investments as they often provide a good match for their long-term liabilities. They have turned their attention to these new asset classes partly as a way to diversify risk, but also as a response to increasing competition within the core real estate investment market from new entrants and from experienced investors increasing existing allocations.
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