RESEARCH

GLOBAL INVESTMENT

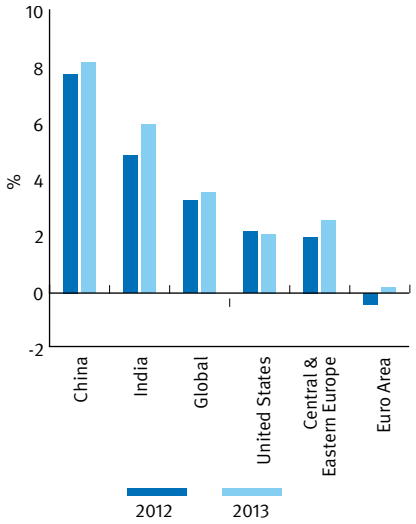
2012

Knight Frank

GLOBAL TRENDS

While the global economic recovery remains fragile, there has been some positive news as we move towards the end of 2012, including the announcement from the US Federal Reserve of a third round of quantitative easing via the purchase of US$40 billion per month of mortgage-backed securities. In Europe meanwhile, the German constitutional court has ratified the European Stability Mechanism and the European Central Bank's bond purchase plan appears to be gaining support.

Figure 1
GDP Growth Forecasts



Source: IMF (October 2012)

The outlook for the global economy largely depends on effective action by Eurozone governments to alleviate the sovereign debt crisis, the extent of the slowdown in China and an agreement on fiscal issues being reached in the US. In the short to medium term, growth in emerging markets is still expected to outpace that of the advanced economies by some margin.

Against this background of uncertainty, real estate investors are risk-averse and investment activity has declined on 2011. Occupational markets also remain cautious, with take-up generally down on last year, although low levels of supply are helping to support rents at the prime end. While a large number of businesses are sitting on significant cash reserves, many remain cost-conscious and reluctant to invest because of the uncertain outlook.

Real Capital Analytics reported global investment transaction volumes of US$157bn in Q2 2012, down 23% on the same period last year. The sharpest fall was in EMEA where volumes were 28% lower, while the Americas and Asia Pacific both recorded a decline of 21%. Investment activity has slowed in most countries and sectors.

In Europe, despite the fall in overall volumes, Germany and the Nordics have retained investor interest, while activity in the UK and France has been focused on London and Paris. Investor demand has generally mirrored wider economic trends and interest in the peripheral Eurozone countries has waned, with investors pursuing a "safety first" policy.

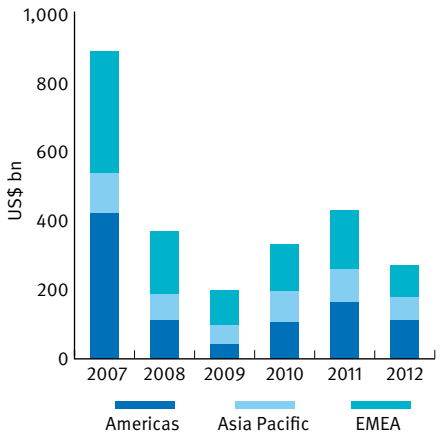
Indeed, concerns about a possible break-up of the Euro area have acted as a significant

Table 1
Global property investment trends – major global deals in 2012*

Transaction	Main sector	Sq m	Location	Price (US$ m)	Buyer
Meadowhall	Retail	139,350	Sheffield, UK	1,230	NBIM
Scotia Plaza	Office	185,800	Toronto, Canada	1,223	Dundee REIT/H&R REIT
Galeria St Petersburg	Retail	200,000	Saint Petersburg, Russia	1,068	Morgan Stanley/Middle Eastern Investor
DNB HQ	Office	80,000	Oslo, Norway	803	DNB
Plantation Place	Office	50,500	London, UK	753	Moise Safra
New Times Square	Office	82,000	Beijing, China	650	Sinotrans/CSC
Złote Tarasy	Retail	113,500**	Warsaw, Poland	633	AXA Group/CBRE Global Investors
50 Connaught Rd	Office	16,300	Hong Kong	629	Agricultural Bank of China
52-60 Ave Des Champs Elysees	Retail	27,000	Paris, France	618	Qatar Investment Authority
Bank of America Building	Office	120,000	Boston, USA	615	Boston Properties/Wellington Management

Source: Real Capital Analytics
Excludes development sites * year to date as at October ** retail and office space

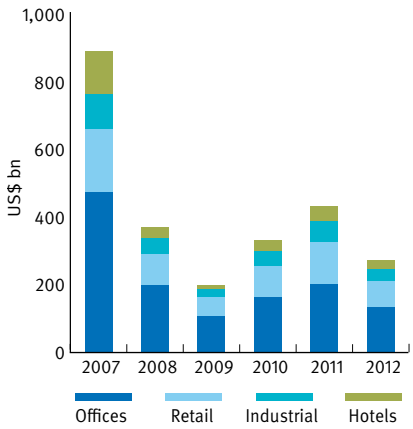
Figure 2
Global share of commercial investment transactions by region



Source: Real Capital Analytics
Data excludes apartments and development sites
2012 year to date as at October

IN TERMS OF GLOBAL CAPITAL FLOWS, THE BIGGEST SOURCE OF MONEY HAS BEEN NORTH AMERICA.

Figure 3
Global share of commercial investment transactions by sector



Source: Real Capital Analytics
Data excludes apartments and development sites
2012 year to date as at October

deterrent to investors and, as a result, investment transaction volumes have fallen markedly in the periphery. However, on a positive note, there is some evidence that Ireland is now beginning to see renewed interest following a dramatic re-pricing.

In terms of global capital flows, the biggest source of money has been North America. Most of this has been invested in Europe, notably in the UK where investors including Canadian pension funds and companies such as Tishman Speyer, Blackstone and Brookfield have made sizeable acquisitions. Germany and France have also been major targets for North American capital, while the UK has also seen growing interest from the Middle East and the Far East, particularly the sovereign wealth funds. Australia has also attracted significant investment on the back of its buoyant economic performance – not to mention its sophisticated, liquid and transparent market – mainly from the US but also from elsewhere in the Asia Pacific region.

Debt markets around the world remain challenging. This year has seen a further tightening in lending terms, with margins increasing in most markets. Banks have been feeling the pressure from a number of quarters, notably the uncertainty surrounding new regulations such as Solvency II and also the ratings agencies. Both of these factors have contributed to a further tightening of the restrictions on lending, as most banks remain firmly in de-leveraging mode. Global CMBS markets – so long a major provider of property finance – remain moribund for the most part, although the US market has seen a revival in activity.

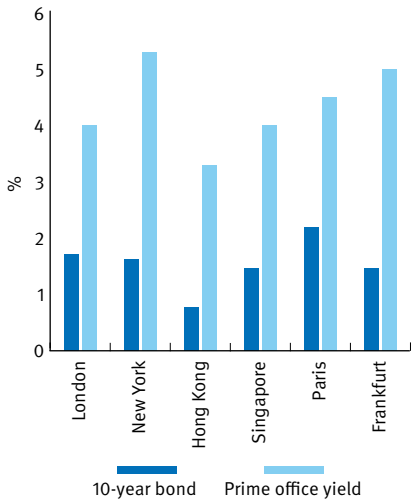
Reduced debt availability has placed larger equity investors at a major advantage over debt-backed players. In the current environment, the larger equity investors such as the REITs, pension funds and sovereign wealth funds are better placed to deliver on transactions – albeit on their terms.

With regard to lending, it had been hoped that the insurers would help to make up the shortfall left by the banks' withdrawal from the market and a small number, including Legal & General and Allianz, have made forays in to real estate lending. However, there remains some uncertainty surrounding the treatment of real estate under Solvency II, which will delay progress on this front.

Unsurprisingly, distress has also featured prominently since the credit crunch, although the US and the UK seem to be further down the road than other markets, particularly Europe which continues to see rising levels of distressed assets. Lenders still have a lot of non-performing loans to divest, which will create additional opportunities for buyers to acquire assets, including large portfolios, once pricing has re-rated.

Another emerging trend has been the increasing activity among High Net Worth Individuals (HNWIs) from locations as diverse as Brazil, South Africa and Azerbaijan. Current demand from HNWIs is focused on trophy assets in core cities and many are now competing successfully against the more traditional commercial property investors for lot sizes ranging from US$20-30m up to several hundred million dollars for the right asset.

Figure 4
Prime office yields and government bonds



Source: Knight Frank
Data as at end of September. Property yields quoted according to local practice

PENSION FUNDS AND SOVEREIGN WEALTH FUNDS

While overall investor sentiment remains cautious, recent economic and financial conditions have allowed large investors such as the pension funds and sovereign wealth funds to increase their exposure to property and, in the process, provide much needed equity at a time when debt finance is in short supply.


Knight Frank recently sold 18 Kowloon East, a mixed use building in Hong Kong, for US$322m.

REASONS TO INVEST IN INTERNATIONAL MARKETS

- Strong competition and limited opportunities in domestic markets
- Take advantage of different economic and property cycles
- Benefit from different tax regimes and legal structures
- Source new investment product
- Grow your investment business
- Diversification – spread the risk across different markets/sectors

The Canadian and Australian pension funds in particular have been increasing their allocations to real estate and are set to become much more high profile on the international property scene. With this in mind, the following sections of our report provide an analysis of recent trends and the key drivers behind their property investment strategies.

Pension funds

Recent years have seen a steady increase in pension fund size and allocations to property. This process is expected to continue in the coming years, driven mainly by ageing populations in developed countries and the growing reliance on self-funding for retirement income. Given property's income-producing qualities, it is expected to figure increasingly in investment portfolios.

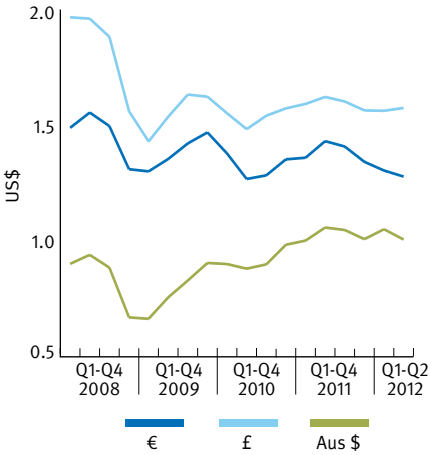
The attractions of property to pension funds are well-known – notably its security of income and its ability to match long term liabilities. There is also some evidence to suggest that property has provided a better hedge against inflation than other asset classes over certain time periods, helped by index-linked leases in many countries.

The recent surge in international activity by the large pension funds has coincided with governments seeking greater involvement from the private sector to fund major infrastructure projects. Indeed, pension funds have seized this opportunity to gain more international exposure by investing in immovable assets outside the "traditional" property universe, such as airports, roads and utilities.

Nonetheless, pension funds have also increased their weighting to traditional property assets such as retail, offices, industrial and hotels. While some individual pension funds may have real estate allocations as high as 15-20%, property allocations in most countries remain below 10% on average. Most recent property investments by pension funds have focused on mature core markets in Europe and North America, although emerging property markets such as the BRIC countries have also seen greater interest, as market transparency improves and restrictions on foreign investment are removed.

However, while many emerging markets offer the prospect of stronger economic growth in the medium term, the property sectors in some of these countries remain immature and are still perceived as higher risk. Barriers to entry remain in some areas, such as restrictions on foreign ownership, in addition to a lack of modern investible stock, transparency and liquidity – issues which would generally deter pension funds.

Figure 5
US dollar exchange rates



Source: Oanda

In order to mitigate risk, many pension funds have entered into JVs with co-investors who have the relevant expertise. A good example of this is the logistics partnership between the Canadian Pension Plan Investment Board and Goodman (formed in 2009) which has joint investments in Australia, Hong Kong and China and has recently been extended to cover North America.

Canadian pension funds

The Canadian pensions industry has some of the largest and most diversified funds in the world, with total assets of over C$1trn, much of which derives from public sector employees. Typically, contributions to public pensions amount to 9.9% of an employee's salary, while contributions to private plans are generally around 12%. According to research by Preqin, there are four Canadian funds among the world's forty largest public pension funds, with only the US having more funds in the ranking.

Another feature of Canadian pension funds is that they tend to manage their investments in-house in order to reduce fees and also have a preference for direct investment in private equity, infrastructure and real estate. A good example of this is the Ontario Municipal Employees Retirement System (OMERS), which aims to manage 90% of its assets in-house by 2015. It is also to reduce its exposure to publicly traded markets from 58% to 53%, in the belief that private market investments are more likely to generate better and more consistent returns over the longer term. An increasing number of pension funds are expected to follow this broad strategy.

In contrast to their Australian counterparts, Canadian pension funds such as the Ontario Teachers' Pension Plan have built a strong international presence in the last decade – in both mature and emerging markets – and in assets as diverse as property in the US and Australia, utility companies in South America and infrastructure in the UK. A number of them now have a network of offices around the world and have acquired considerable experience in global markets. Indeed, this trend is expected to continue, as the funds diversify away from their relatively small domestic market.

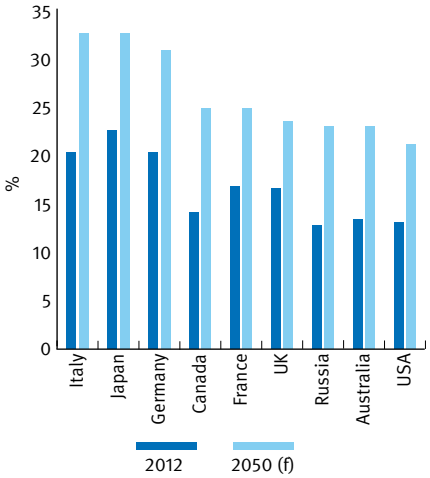
Alongside the increasing internationalisation of the Canadian pension funds, allocations to property have risen steadily in recent years, from 5.2% of total assets in 2000 to 9.4% in 2011 (Figure 7). International real estate is already accounting for an increasing proportion of portfolios and the overall allocation to property is expected to exceed the 10% mark in the next few years. It is worth noting that CPPIB's allocation to real estate (excluding infrastructure) rose from zero in 2000 to 10.6% in 2011.

Table 2
Major Canadian pension funds

Fund name	Total assets (C$m)
Canada Pension Plan Investment Board (CPPIB)	161,600 *
Ontario Teachers' Pension Plan	116,258
Ontario Municipal Employees Retirement System (OMERS)	55,802
Public Service Pension Plan	42,310 **
Quebec Government & Public Employees Retirement Plan (RREGOP)	41,982
Healthcare of Ontario Pension Plan (HOOPP)	40,000
B.C. Municipal Pension Fund	27,998
Alberta – Local Authorities Pension Plan	19,617
B.C. Public Service Pension Plan	18,635
Ontario Pension Board	18,521 ***

Sources: 2011 CIIN Pension Fund Survey, annual reports
Data as at December 2011 except * June 2012 ** March 2011 *** estimate

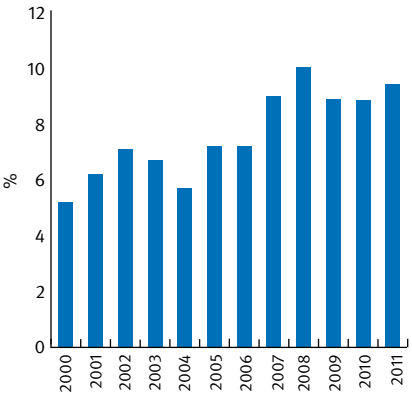
Figure 6
Ageing populations: forecast demographic changes
% of population aged 65+



Source: United Nations

RECENT YEARS HAVE SEEN A STEADY INCREASE IN PENSION FUND SIZE AND ALLOCATIONS TO PROPERTY.

Figure 7
Canadian pension funds' allocations to real estate



Source: Pension Fund Investment Association of Canada (data based on Sponsor Organisations and excludes non-reporting funds)

Australian pension funds

The Australian pension system is one of the most respected and envied in the world for its size, sophistication and the wider benefits it brings to the country's economy. However, unlike the Canadians, the Australian pension or "superannuation" funds have not yet made significant inroads into international property and remain focused on their domestic market.

The industry currently has almost A$1.4trn of assets under management and around 9.7% of this is allocated to real estate. The system is based around compulsory 9% employer contributions of all employees' salaries, although legislation means that this will rise gradually to 12% by 2020 – which will provide a significant boost to these funds.

It is estimated that the allocation to property will increase to 10.5% in the next 1-2 years, with some analysis suggesting that up to A$40bn of additional capital may be targeted at the real estate sector. As a result, it is likely that a high proportion of this extra money will be channelled in to new markets outside Australia, in order to source enough investment stock. Overall portfolio sizes have increased in recent years, a trend which is expected to continue.

In addition to the continuing growth in cross border property investment, these changes will ensure that these Australian giants will be making waves in new markets before too long. Initial target countries are expected to be the larger, more transparent and liquid markets of Europe and North America, given that most of these funds have limited international experience and will initially adopt a relatively cautious investment strategy.

Sovereign Wealth Funds

The growth of the Sovereign Wealth Funds (SWFs) has continued, with research from TheCityUK suggesting that the aggregate value of assets under management rose by 9% in 2011 to reach US$4.8trn, which is forecast to increase to US$5.2trn in 2012. The increase in part reflects the creation of new funds, in addition to the recapitalisation of some funds following drawdowns in previous years.

As with the pension funds, the financial crisis and subsequent limited availability of finance has provided Sovereign Wealth Funds with significant investment opportunities across a range of asset classes, including real estate. Most have continued to invest during the downturn, primarily in mature economies. From 2005 to 2011, the US and the UK were the leading recipients of SWF investment, taking 19% and 17% of the global total respectively. However, more recently, there has been a degree of shift away from riskier European markets and an increasing focus on emerging markets.

SWFs are at a considerable advantage in the current investment market, notably in respect of their sheer scale and ability to provide large amounts of equity. They have an added advantage in that they generally do not have to meet liabilities in the same way as pension funds and insurance companies, which enables them to take a longer term view. However, some are renowned for slow decision-making and many prefer off-market deals.

New Sovereign Wealth Funds continue to emerge and deploy capital, with Mongolia, Italy and Nigeria establishing funds in 2011. Earlier this year, the West African state of Gabon announced plans to establish a fund derived from a tax on oil receipts, while Bolivia, Canada, India, Japan and Thailand are also contemplating or in the process of setting up funds.

According to data from Real Capital Analytics, the Qatar Investment Authority was the largest sovereign wealth investor in European property in the twelve months to June, spending over US$4.33bn across eight deals, including the acquisition of 52-60 Avenue des Champs Elysées in Paris for around €500m. Norges Bank Investment Management, acting on behalf of Norway's sovereign wealth fund, has recently been active, notably with its acquisition of London & Stamford's 50% stake in Meadowhall shopping centre near Sheffield in the UK.

PROPERTY INVESTMENT DRIVERS FOR PENSION FUNDS

- Ageing populations in developed countries
- Long term, secure income
- Stable and potentially higher returns
- Low correlation with other asset classes
- Ability to match long term liabilities
- Possible inflation hedge

Table 3
Major Australian pension funds

Fund name	Type	Total assets (A$m)
AMP Superannuation Savings Trust	Retail	51,484
AustralianSuper	Industry	43,383
State Public Sector Superannuation Scheme	Public Sector	41,205
Colonial First State FirstChoice Superannuation Trust	Retail	41,162
The Universal Super Scheme (MLC)	Retail	32,192
First State Superannuation Scheme	Public Sector	31,834
Unisuper	Industry	30,882
Retirement Wrap (BT)	Retail	28,662
OnePath Masterfund (ANZ)	Retail	26,716
Retail Employees Superannuation Trust (REST)	Industry	21,095

Source: Australian Prudential Regulation Authority
Data as at June 2011 (latest available)

OUTLOOK

There remain a number of immediate risks to the global economy and, as many analysts predicted, the recovery from the recent financial crisis is proving to be longer and more arduous than after previous downturns. Recent GDP forecasts for 2013 have been revised down across the board, with growth in the stronger performing emerging markets now also expected to slow.

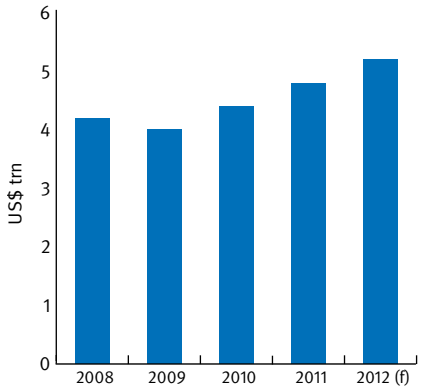
In addition to the possibility of a fiscal tightening in the US, the sovereign debt-related issues in the Euro area are perhaps the most significant impediment to a speedier recovery and, while some progress has been made, implementing more permanent solutions will take time. As a result, most investors will remain risk averse in the short term.

Nonetheless, the case for real estate investment remains strong, with property yields in most global markets offering a significant premium over government bonds. Property also offers stable income-producing qualities against the current backdrop of low interest rates and unpredictable inflation, in addition to the ability to increase income and capital value through asset management. However, while the economic uncertainty continues, capital is expected to remain focused on less risky core and core plus markets.

With yields at very low levels in many of the major global city markets and rents not yet seeing much uplift, questions over future performance will inevitably arise. As a result, some investors will begin to look at other markets in search of better value and demand for more secondary stock/locations in the larger gateway cities should gradually increase as we move in to 2013.

Equally, with debt finance likely to remain constrained for the foreseeable future, the larger equity players – including the pension funds and sovereign wealth funds – will dominate the investment landscape, at least for the next year or two. New entrants to the debt market are likely, including more real estate debt funds targeting an increasingly broad range of assets and risk profiles. Indeed, there has already been a proliferation of debt funds, particularly in the last year, which have attracted significant amounts of capital.

Figure 8
Sovereign Wealth Funds: assets under management



Source: TheCityUK

Table 4
Major Sovereign Wealth Funds

Fund	Assets under management (US$ bn)	Country	Inception	Source
Abu Dhabi Investment Authority	627	UAE-Abu Dhabi	1976	Commodity
SAFE Investment Company	568	China	1997	Non-Commodity
Government Pension Fund – Global	560	Norway	1990	Commodity
SAMA Foreign Holdings	473	Saudi Arabia	n/a	Commodity
China Investment Corporation	410	China	2007	Non-Commodity
Kuwait Investment Authority	296	Kuwait	1953	Commodity
Hong Kong Monetary Authority Investment Portfolio	293	China (HK)	1993	Non-Commodity
Government of Singapore Investment Corporation	248	Singapore	1981	Non-Commodity
Temasek Holdings	157	Singapore	1974	Non-Commodity
National Social Security Fund	135	China	2000	Non-Commodity

Source: SWF Institute, TheCityUK estimates
Data as at end 2011

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