



# ACTIVE CAPITAL

THE REPORT 2018

## Active Capital 2018

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# Foreword

We are delighted to present this second edition of *Active Capital*, in which we share our analysis, insight and opinions on the trends shaping global real estate.



**Andrew Sim**  
Head of Global  
Capital Markets

Drawing on local expertise from across our global network, we explore the emerging capital superhighways, and identify the factors exerting the greatest gravitational pull on a country's inbound capital flows, before turning to active purchasers and the property sectors on which they are focused.

This is a marketplace supported by a recovery in global growth that is still in full swing. It is one that is re-internationalising as it attracts ever-greater investor demand.

However, it is also a mature cycle in many locations and, with macroeconomic change on the horizon, we believe it has never been more important to understand both the nuances within the sector as well as the wider financial market context.

Knight Frank remains at the forefront of global capital markets. We hope you find this edition of *Active Capital* even more thought-provoking than its predecessor, and enjoy reading it as much as we enjoyed compiling it.



**It has never been more important to understand both the nuances within the sector as well as the wider financial market context.**



# Overview

Front cover artwork:  
Johanna Pikver

## Data and capital flows

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Cross-border investment grew by more than 10% in 2017 and, for the first time ever, the Asia-Pacific region was responsible for more of it than anywhere else. What can the emerging trends of the past year tell us about the outlook?

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Which regions and countries are the most prolific exporters of real estate capital? Where is this investment directed, and what sort of assets is it targeting? We analyse the major capital routes of the present, and give our predictions for those of the future.

### 12 From the Knight Frank Data Lab: the rules of attraction

Real estate investment is increasingly global, but the bulk of cross-border purchases still take place within a relatively small group of markets. Is this narrow focus still warranted given the often intense competition for assets in these locations, and increasing levels of transparency seen elsewhere? Using our in-house gravity model, we identify a number of markets that we believe deserve to see higher volumes of inward investment than they do at present.

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## Sources of demand

### 16 Titans at the gate: private equity raises the stakes

Huge amounts of private equity capital has been raised in recent years, in ever-larger funds: over a quarter of a trillion dollars is now waiting to be spent on real estate. What is behind this rise in scale, and what does it mean for the future of real estate equity funds, both great and small?

### 20 The wealth of nations

With economic recovery in full swing, global wealth is on a seemingly unstoppable rise. More of it is being invested in real estate, either directly, or via allocations from asset managers. We analyse data from our *Wealth Report* to understand where future growth in private wealth will come from over the next five years, and identify three trends for the year ahead.

## Dynamic sectors

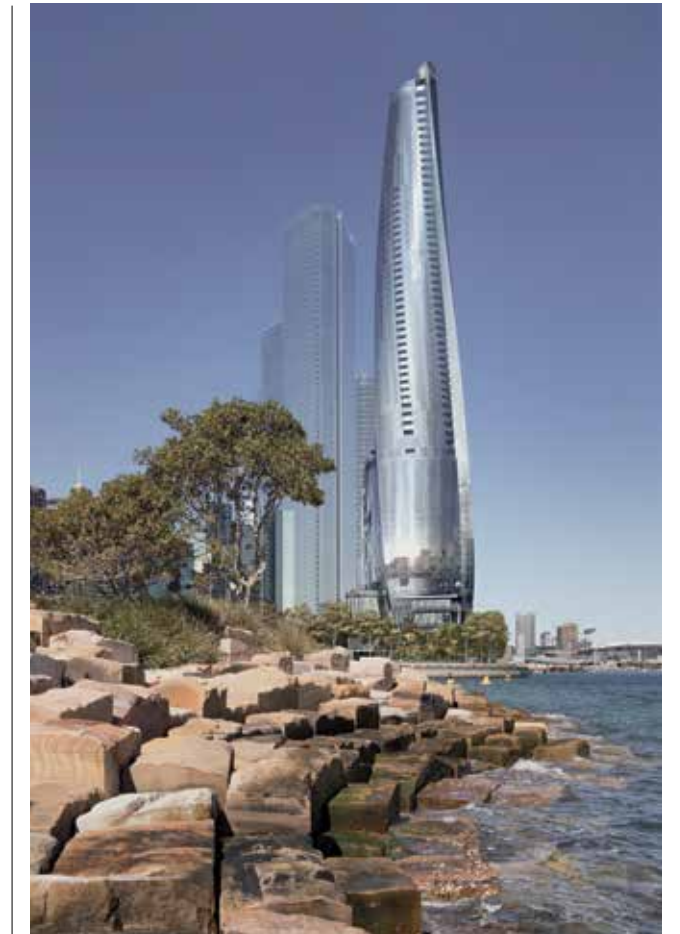
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Logistics property is one of the hottest sectors in commercial real estate. While the opportunity in Western markets is focused on capturing evolving retail trends, in Asia-Pacific markets there is much more in the mix, from manufacturing to infrastructure to global trade.

### 28 Building the world

Growing demand from investors for properties overseas has been one of the defining features of the world's leading urban housing markets. Where the investor has led, developers have followed. We provide our view on the outlook for cross-border development in a selection of the world's leading cities.



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What are the themes that will shape the increasingly international market over the coming years?

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A decade on from the global financial crisis, how sustainable is the maturing recovery and what are the risks on the horizon?

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The wealth of nations

# Shifting capital flows

Globally, total real estate investment activity edged up by a modest 3% during 2017, belying a market that felt far more active, and with good reason: while volumes traded saw little change, the source, destination and even the rationale behind cross-border capital flows is evolving rapidly.

## SHIFTING SOURCES

The global real estate market is re-internationalising. In 2017, 32% of all transactions by volume involved cross-border purchases, up from 25% during 2009-2011. However, this isn't simply a return to the levels and mix of pre-global financial crisis trade. While Europe and North America continue to invest similar volumes of capital abroad, for the first time ever they were eclipsed by Asia-Pacific, from which US\$90 billion flowed in 2017.

Which region will be the greatest exporter of cross-border capital flows in 2018? As we explore later, a slowdown in outbound capital from China and Hong Kong might suggest that Asia will slip back temporarily. However, we believe the extent of this fall will be countered by potential for greater investment from Japan, South Korea and other major Asian markets. Much of this demand will emanate from mature institutions, used to acquiring assets globally, and more likely to consider opportunities beyond well-known gateway markets than investors looking overseas for the first time.

US investors will continue to acquire significant volumes of real estate overseas, although the impact of domestic tax changes will offer up compelling opportunities for investing at home. A similar situation will face European investors, who currently benefit from the prospect of strong returns in their local markets. Outbound capital from the Middle East has slowed in recent years, but this may be about to change as rising oil prices boost revenues and sovereign wealth inflows.

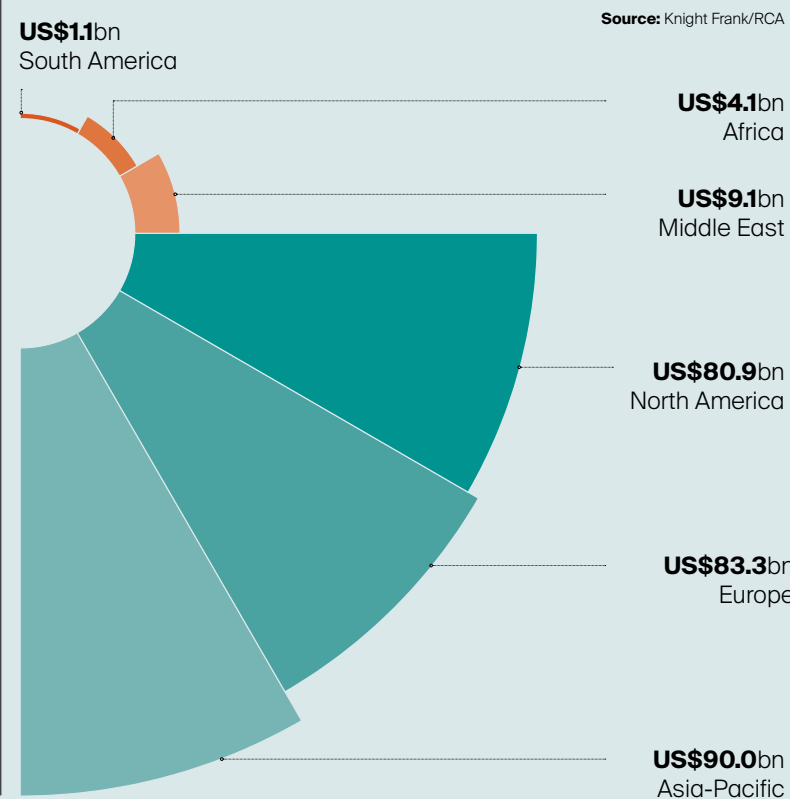
Although the overall volume of cross-border capital flows has changed little since 2016, there has been a clear shift in the type of investors active in the market. In volume terms, the biggest increase has come from private equity funds, which after a period building up dry powder, increased their cross-border investment by over 60% in 2017. We expect 2018 volumes will show them to be even more active: US\$124 billion of fresh capital was raised in 2017, and many of the North American funds behind the largest of these pools have a global or European remit.

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For the first time ever, Europe and North America were eclipsed by Asia-Pacific, from which US\$90 billion flowed in 2017.

Long-term investors such as pension funds and sovereign wealth funds have also returned to the cross-border market at scale, the latter doubling investment in 2017 vs. 2016. This is part of a structural shift which has seen growth in capital flows from these investor groups far outstrip other investor types over the past decade.

The most significant fall in cross-border flows has been from real estate investment trusts and other listed property companies. The volume of assets purchased has fallen by around half over the past two years.

Cross-border capital outflows by source, 2017



## DESTINATION

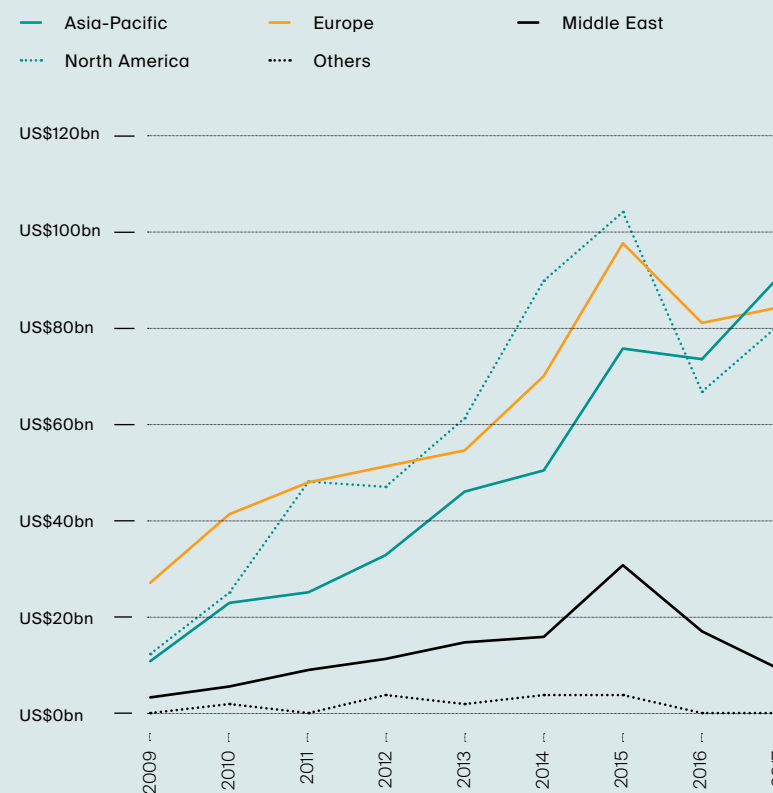
When it comes to cross-border capital inflows, the US, UK and Germany held the top three spots in 2017, as they have done since 2010. However, with a great variety of investors currently targeting continental European markets, it is no surprise to see the likes of Spain, France, Austria and the Netherlands rising up the ranks too. Continental markets will remain compelling as, despite strong pricing, opportunities to capture future rental growth remain.

Beyond the limelight, but no less interesting for that, are markets that are yet to see significant volumes of inbound real estate investment. These are countries where the overall volume of capital inflows remain relatively low, and volatile, but are ultimately growing very quickly: India is perhaps the standout example of recent years, with investment growing by 600% since 2012 to reach US\$2.6 billion in 2017.

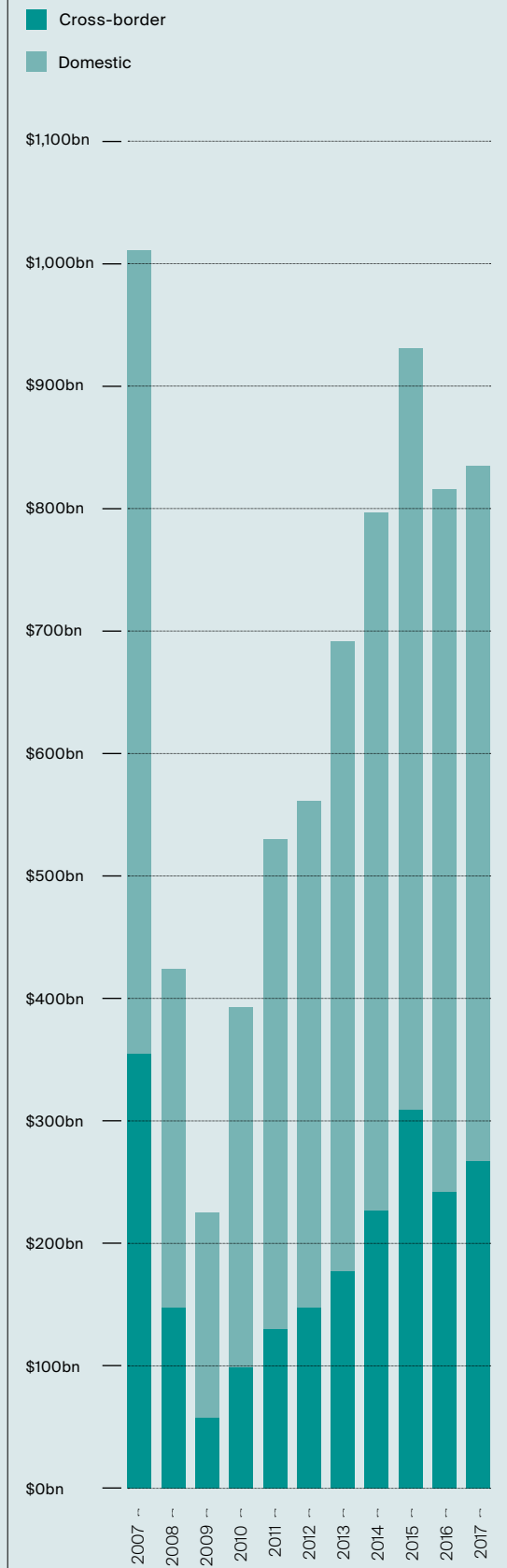
The next part of our research is all about analysing these trends, both at the macro and micro level. We begin by identifying the 'capital superhighways' - the main sources and destinations of real estate capital at a continental and country level. We then use our in-house gravity model (see page 13) to determine locations that we believe could be set for higher inbound investment.

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Beyond the limelight, but no less interesting, are markets that are yet to see significant volumes of inbound real estate investment.

The evolving sources of cross-border capital



Global investment volumes





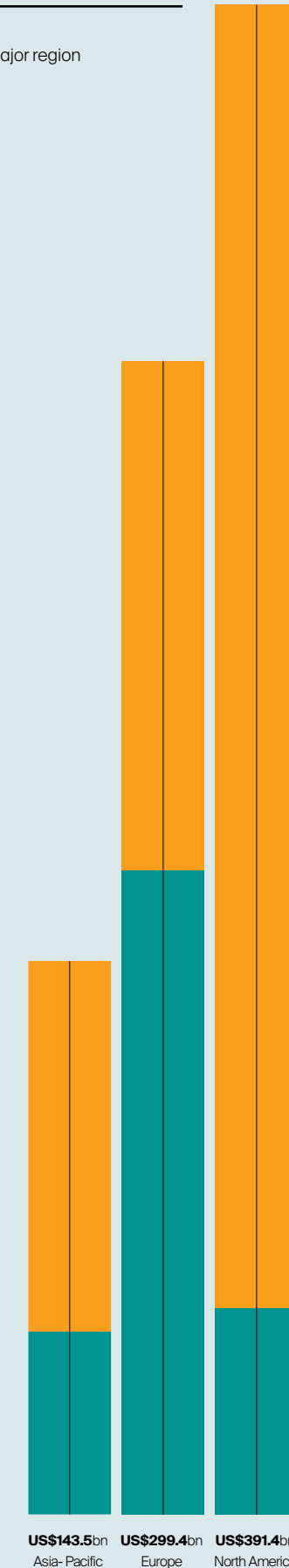
# Mapping the capital superhighways



## Inbound capital

Investment volumes in 2017 by major region

- Cross-border
- Domestic



Our detailed analysis of capital flows begins by looking at where investment has taken place globally.

At the continental level, North America continues to see a greater volume of activity than anywhere else, although the vast majority is from domestic investors, with less than 15% of volume accounted for by purchasers from abroad.

By contrast, more than half of the investment that took place in Europe involved a buyer from a different country. Part of the reason for this is the high volume of cross-border trading that takes place between European countries: intra-continental trade in Europe reached US\$65 billion in 2017. But that is far from the whole story. In particular, it is clear that Asia's role is growing rapidly, both as a source of outbound capital flows, and as a destination for inward investment. Indeed, both Asia-Pacific investment into Europe and European investment into Asia-Pacific doubled during the year.

In the longer term, we predict the share of overseas investment in Asia-Pacific markets will gradually begin to catch up with that seen in Europe. However, in the short term, so strong is the focus from both Asia-Pacific and North American investors that Europe's cross-border share could also continue to grow.

# US\$65bn

The volume of intra-continental investment that took place in Europe during 2017.

Image: Tom Grimbert

Source: Knight Frank/RCA

US\$143.5bn Asia-Pacific  
US\$299.4bn Europe  
US\$391.4bn North America



**Cross-border flows from regions into countries**

Where the country of origin is not the same as the country of investment

Source: Knight Frank/RCA

While much cross-border activity takes place at the intra-continental level (such as wider Asian investment into China or Australia, or Canadian investment into the US), it is also clear that a number of markets have broad appeal to investors across the world. As we discuss on pages 12 to 15, our view is that this mix of countries will become more diverse over time.

**ORIGIN CONTINENT**

**Africa**  
US\$4.1bn

**Asia-Pacific**  
US\$90.0bn

**Europe**  
US\$83.3bn

**Middle East**  
US\$9.1bn

**North America**  
US\$80.9bn

**South America**  
US\$1.1bn

**DESTINATIONS TOP FIVE PER REGION**

Australia	US\$6.3bn
Bulgaria	US\$0.8bn
China	US\$8.8bn
France	US\$5.1bn
Germany	US\$6.8bn US\$15.9bn US\$0.9bn US\$11.9bn
Hong Kong	US\$0.3bn
Hungary	US\$0.3bn
Netherlands	US\$5.3bn US\$0.5bn US\$5.0bn
Panama	US\$0.3bn
Poland	US\$1.3bn
Romania	US\$0.3bn
Spain	US\$0.3bn US\$8.5bn US\$0.1bn
United Kingdom	US\$0.4bn US\$19.6bn US\$6.8bn US\$3.3bn US\$12.6bn US\$0.1bn
United States	US\$19.8bn US\$13.0bn US\$2.8bn US\$14.0bn US\$0.4bn
Other	US\$0.9bn US\$28.8bn US\$37.6bn US\$1.3bn US\$29.0bn

**Cross-border flows from different types of investors**

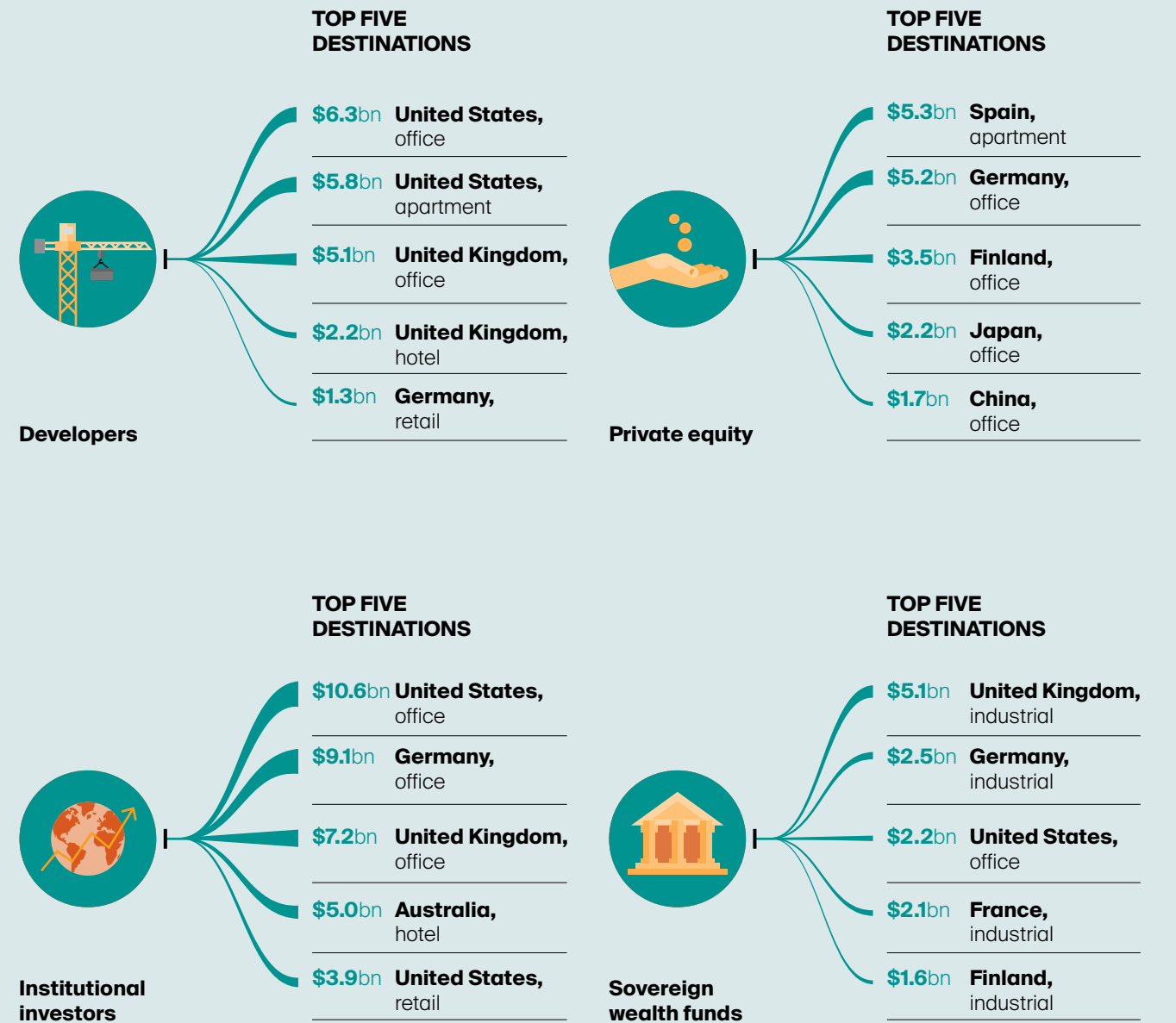
Excluding developments

There is significant variation in the foreign real estate acquired by different types of investors. The approach taken by developers and institutional investors has tended to see them invest consistently in a relatively broad range of established, liquid markets.

A similar mix of markets is also targeted by private equity and sovereign wealth funds, but the difference is that rapid growth in the scale of purchases made by these investors makes the ranking of destinations increasingly volatile from year to year. Spanish apartments and UK industrial real estate topped

their respective lists in 2017 largely due to a few multi-billion dollar platform transactions. Such activity will certainly remain a feature of the global market over the coming years, and will be exacerbated by the high volume of capital inflows that such funds are seeing.

Source: Knight Frank/RCA



From the Knight Frank data lab:

# The rules of attraction

Why do some countries receive more inbound real estate investment than others? What drives these cross-border flows – and should some markets be getting more inward investment than they currently do? Our gravity model sets out to find the answers.

The world of real estate is globalising. The volume of cross-border transactions has grown by 80% over the past five years, but that increase has been heavily concentrated within a limited number of locations. In fact, the top five countries by capital inflows have typically accounted for well over 60% of total cross-border investment over the decade. The UK has been the top destination for cross-border capital for six of the past ten years.

So why do relatively small, medium growth countries such as the UK attract more inbound capital than larger or faster growing rivals? The answers are well rehearsed: they benefit from a significant market size, with large and high quality assets, good levels of transparency, consistency in the rule of law, to name just a few. Of course there are also softer factors too, such as familiarity, and these often play an equally valid role in the choice of investment location, particularly for many first-time overseas investors.

But is there a danger that accepted notions of attractive investment markets overshadow more quantifiable data on factors such as demographic trends or income growth prospects? If we were to account for these factors, would we expect some markets to receive more inbound investment than they do at present?

## GRAVITATIONAL PULL

In order to put the question to the test, we have developed our own version of a gravity model to analyse cross-border real estate investment inflows. The aim was to identify markets that currently receive less inbound capital than their demographic, economic and business environment rankings might suggest.

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Interestingly, the income tax rate and the number of days it takes to complete a property deal were positively correlated with deal flow.

<sup>1</sup> The main exception to this is the work carried out by McAllister and Nanda of Henley Business School.

Gravity models are common in the field of international trade, helping to predict the flows between locations based on mainly economic factors, yet there has been little application of the technique to real estate investment.<sup>1</sup>

By testing the model with a large number of different inputs, we were able to refine it to the point where it explains 80% of the variation in annual investment flows between countries. As a sense check, investment volumes for the US and UK - arguably the most developed cross-border markets - were predicted to within a few per cent of actual levels.

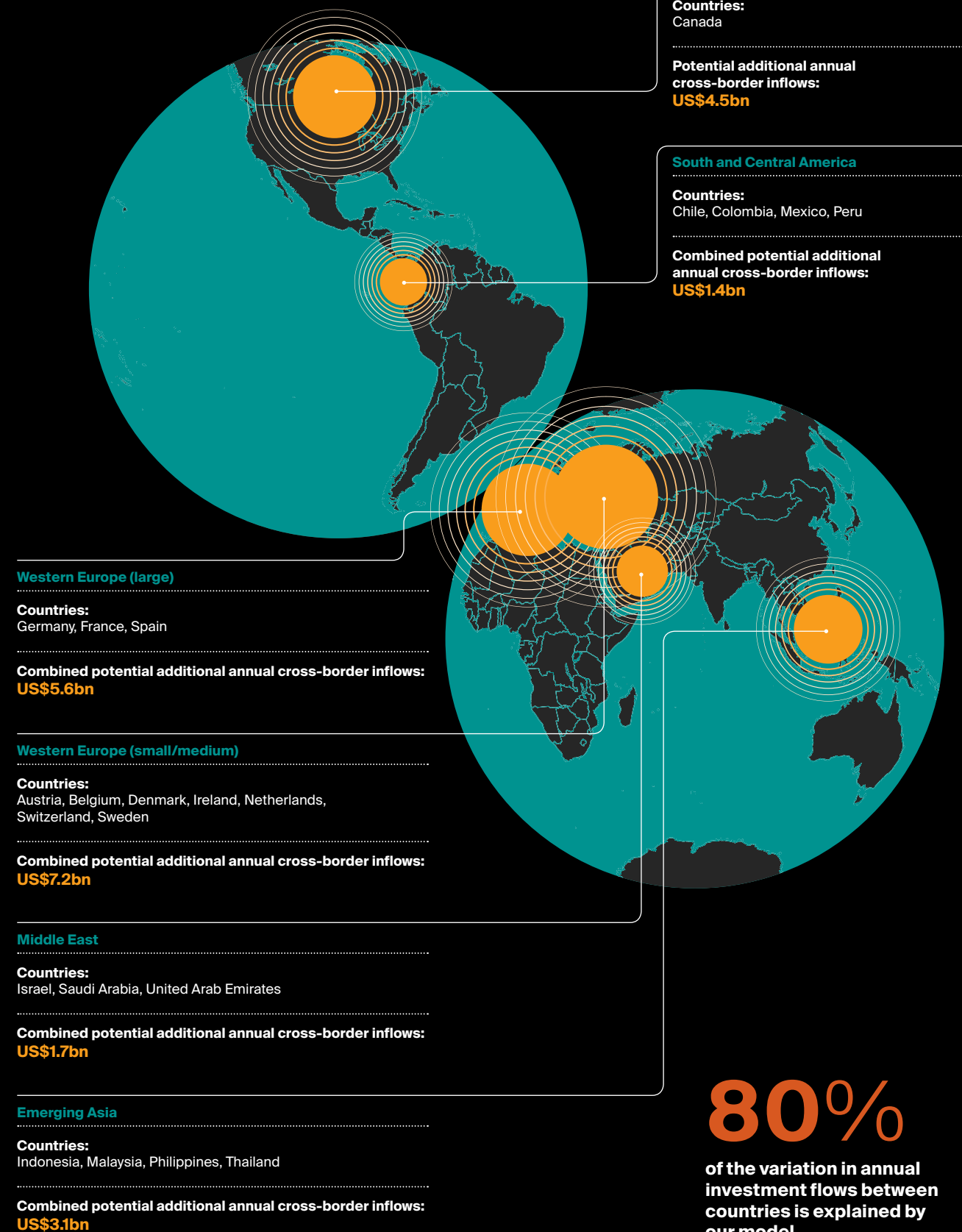
We explored around 40 variables for this model, carefully analysing the importance of each while bearing in mind factors such as the likely high level of correlation between the variables.

For this version of the model we focused on identifying the key factors that explained the most variation in direct real estate investment flows. Many of the factors that we initially identified were discarded due to high correlation with other key factors such as GDP. Variables that were theoretically promising such as the country's GINI coefficient (which shows wealth distribution), or using volume of flight routes between countries as opposed to a pure physical distance separation, were excluded as they were found to add no improvement to the existing model.

Interestingly, the income tax rate and the number of days it takes to complete a property deal were positively correlated with deal flow. These variables are likely to be acting as proxies for other factors such as a country's economic health or level of development in the eyes of an investor.

## THE GRAVITY MODEL

The opportunity for additional inbound investment



**80%**  
of the variation in annual investment flows between countries is explained by our model

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**There are a number of regions that could see higher levels of cross-border inflows.**

#### FUTURE HOTSPOTS

Comparing the volume of inflows predicted by the model with the actual volume of transactions seen in 2017 gives an idea of the theoretical potential for additional investment. The results showed that there are a number of countries and regions that might reasonably be expected to see significantly higher levels of cross-border inflows each year, based on the factors that typically drive inbound investment. In the graphic on the previous page, we have grouped these countries by region and indicated their combined potential for additional annual investment.

Of course, some markets have well-understood reasons for seeing a lower-than-expected volume of inbound investment.

In Canada, for example, the high number of sophisticated, locally based global investors can effectively “crowd out” demand from foreign investors. Other countries operate constraints such as ownership restrictions, which preclude investment from non-domestic sources.

Fundamentally, however, the model accords with our outlook for global capital flows. We do not envisage the demand for real estate in the established European market slowing in the short term, but we recognise that the hunt for returns is causing investors to give greater consideration to emerging markets. Our model demonstrates that there is a quantifiable logic to these trends.

Few of the hurdles to inbound investment are insurmountable in the longer term. We predict that the fixed or binary factors currently identified as drivers of investment, such as location, language and colonial ties, will become less important over time. Instead, variable factors such as transparency, economic growth and market liquidity will play a stronger role in determining the volumes of capital inflows to real estate.

#### THE MODEL IN DETAIL

Past studies have tended to focus on analysing the total amount of direct real estate flows into countries, rather than on the flow of direct real estate investment between an/the origin country and destination country. We have used a spatial interaction model, also called a gravity model, to analyse these flows.

Such models have long been used to predict levels of cross-border investment and trade. They start from the premise that there are certain factors that can generate investment in one country, and certain factors that can draw that investment towards a specific destination. In addition, there is a cost, usually physical distance or a monetary cost, which grows with the measurable separation between origin and destination country.

For this particular research, which is part of a wider study, we have focused on the destination aspect of direct real estate investment flows by using an origin-constrained spatial interaction model. We were interested in identifying which factors best predict the flow of direct real estate investment as well as using the resulting model to analyse countries that were over- or under-invested in according to the model. We can then look at these countries to see if there are obvious reasons that explain the findings.

Data used in the model was sourced from the World Bank, The Heritage Foundation, MSCI and the CEPII research project.

The model produced a highly satisfactory outcome in that it explained over 80% of the variation in investment flows. The final model found that shared ethnographic elements such as common official language, religion and a colonial history increased the amount of direct real estate investment between countries. Not surprisingly, a country's economic productivity and wealth were found to be linked to the volume of investment that was likely to be received by that country.

We found that the greater the dispersion between the origin and destination countries' scores in the Index of Economic Freedom, the lower the investment between those countries. Currency fluctuations also played an important role in predicting the flows between countries. Countries that share a border with each other were more likely to see greater investment levels, which ties in with the finding that as the physical distance grew between two countries the flow of real estate investment fell.

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**We predict that the fixed or binary factors currently identified as drivers of investment, such as location, language and colonial ties, will become less important over time.**

#### WE FOUND THAT THE BEST PREDICTORS OF CROSS-BORDER INVESTMENT INTO A COUNTRY INCLUDED:

- + volume and growth of the destination country's GDP per capita
- + whether the destination country was in the European Union
- + percentage of MSCI's Real Estate Index coverage
- + whether the destination country had been a colony of the origin country
- + whether the countries were contiguous
- + percentage of shared common religious worship amongst the population
- + whether the countries shared an ethnographic language.

#### ELEMENTS THAT WERE LINKED TO A REDUCED FLOW OF DIRECT REAL ESTATE INVESTMENT INTO A COUNTRY INCLUDED:

- whether the currency of the destination country had fallen against that of the origin country in the last three years
- whether the Index of Economic Freedom score in the destination country is higher than that of the origin country
- the distance between population weighted centres within the country, with greater distance being linked to lower flow
- whether the destination country had been a coloniser of the origin country
- whether the origin and destination country had both been former colonies of the same country.

The general equation<sup>2</sup> for a production constrained gravity model is:

$$T_{ij} = A_i O_i W_j^\alpha d_{ij}^{-\beta}$$

Where:

$T_{ij}$  is the direct real estate flow between origin country/and destination country  $j$

$W_j^\alpha$  is a vector of attributes relating to the attractiveness or otherwise of all destination countries

$d_{ij}^{-\beta}$  is the physical distance between the two countries, based upon weighted population country centres

$\alpha$  is a matrix of coefficients to be estimated by the model.

$$O_i = \sum_j T_{ij}$$

$$A_i = \frac{1}{\sum_j W_j^\alpha d_{ij}^{-\beta}}$$

Where:

$A_i$  is a balancing factor to ensure that the flow estimates from each origin sum to the known origin country totals  $O_i$

As we are using Poisson regression to estimate our model we can transform the general equation by taking natural logarithms of each side to form the equation.

$$\lambda_{ij} = \exp(k + \mu_j + \alpha \ln W_j - \beta \ln d_{ij})$$

Where:

$\lambda_{ij}$  is the poisson distributed mean of direct real estate flows between countries  $i$  and  $j$

$k$  is a constant

$\mu_j$  is a fixed effect variable to ensure the flow estimates from each origin sum to the known origin country totals  $O_i$

<sup>2</sup> For further details see [https://rpubs.com/adam\\_dennett/259068](https://rpubs.com/adam_dennett/259068)



# Titans at the gate: The rise of the real estate megafunds

The biggest private real estate funds are getting bigger, leaving a long tail of smaller rivals. What is fuelling this consolidation, and what does the pursuit of scale hold for the future?

**Left:**  
Burj Khalifa, Dubai  
**Image:**  
Clay Banks

## AN INDUSTRY OF GIANTS

The private equity industry has thrived in recent years: since 2012 there has been over US\$3.6 trillion of private capital raised. Traditional private equity, in the form of buyout funds, still represents the largest share of the market, but real estate is firmly in second place.

Real estate-focused private equity has seen its own rapid expansion during the global real estate recovery of the past eight years. Data from Preqin shows that at US\$565 billion in mid-2017, assets under management have more than doubled since 2009, and while capital raising slowed in 2016 and 2017, this did not prevent the volume of dry powder (funds allocated to real estate but as yet unspent) from reaching a record US\$266 billion at the end of March 2018. Today, numerous funds have upwards of US\$10 billion under management.

## WHY REAL ESTATE?

Real estate funds have attracted capital for a variety of reasons, including the promise of diversification benefits, as a means to put relatively inexpensive debt to work, and most obviously, the lure of healthy performance. In the three years to June 2017, private real estate funds saw annualised returns of 10.7%, outperforming all other types of private capital bar traditional private equity.

However, there are clear nuances among investor types. Institutions, such as pension funds, have sought to close a funding gap created or exacerbated in the years after the financial crisis. They have allocated capital to private real estate funds hoping for both strong returns and a greater degree of income stability than is offered by many competing asset classes. Others, such as family offices, value the privacy that private

equity investment managers can offer, as well as the potential for less bureaucracy and faster deal-making as well as diversification.

The type of funds that have been successful in raising capital has evolved as the real estate cycle has matured. Today, with yields on directly held real estate at or near record lows in many developed markets, there is a recognition that the years of truly exceptional returns from property are over for now, at least in certain locations. Against this backdrop, some investors have sought to maintain expected performance by investing in vehicles that are further up the risk curve. In Q1 2018 only US\$0.6 billion was raised for funds targeting core property, while over US\$20 billion was raised for opportunistic funds.

Increasing risk has not been the only approach, however. Some investors have turned to real estate debt funds as a defensive play, reasoning that lenders are less exposed to the impact of asset value fluctuations than asset owners. Real estate debt funds raised over US\$28 billion in 2017, the highest volume on record.

## CONSOLIDATE TO DOMINATE

As well as changes driven by the timing of the real estate market cycle, there is a deeper structural shift at work: the consolidation of capital into larger and larger funds. The biggest funds are continuing to grow rapidly, creating a consolidation at the top, followed by a long tail of smaller funds.

In recent years, the number of real estate funds closed each quarter has declined, but the average volume of capital raised in these funds has risen: in 2016 the average was US\$370 million, but by Q1 2018 it had risen to US\$690 million. What's more, this growth has not been evenly distributed.

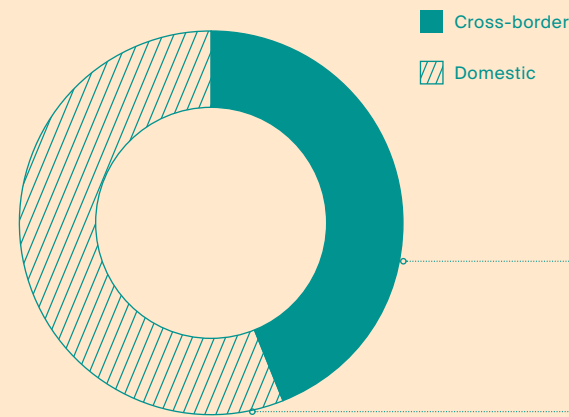
Unspent capital  
targeting real estate

# US\$0.27tn

**US\$690m**

the average size  
of fund close in  
Q1 2018

**Equity fund purchases**  
2017



**44%**

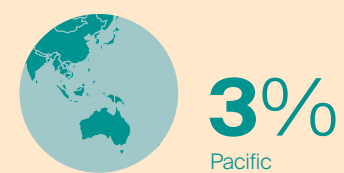
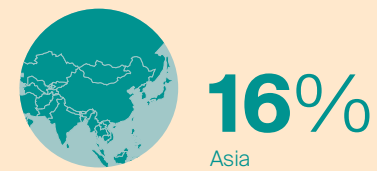
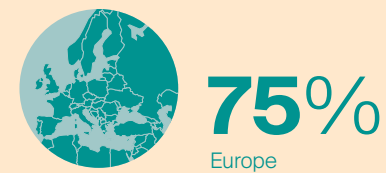
The majority of real estate investment still takes place in the country in which the fund is domiciled. However, at 44% the share of cross-border investment in 2017 was the highest since 2009.

**56%**

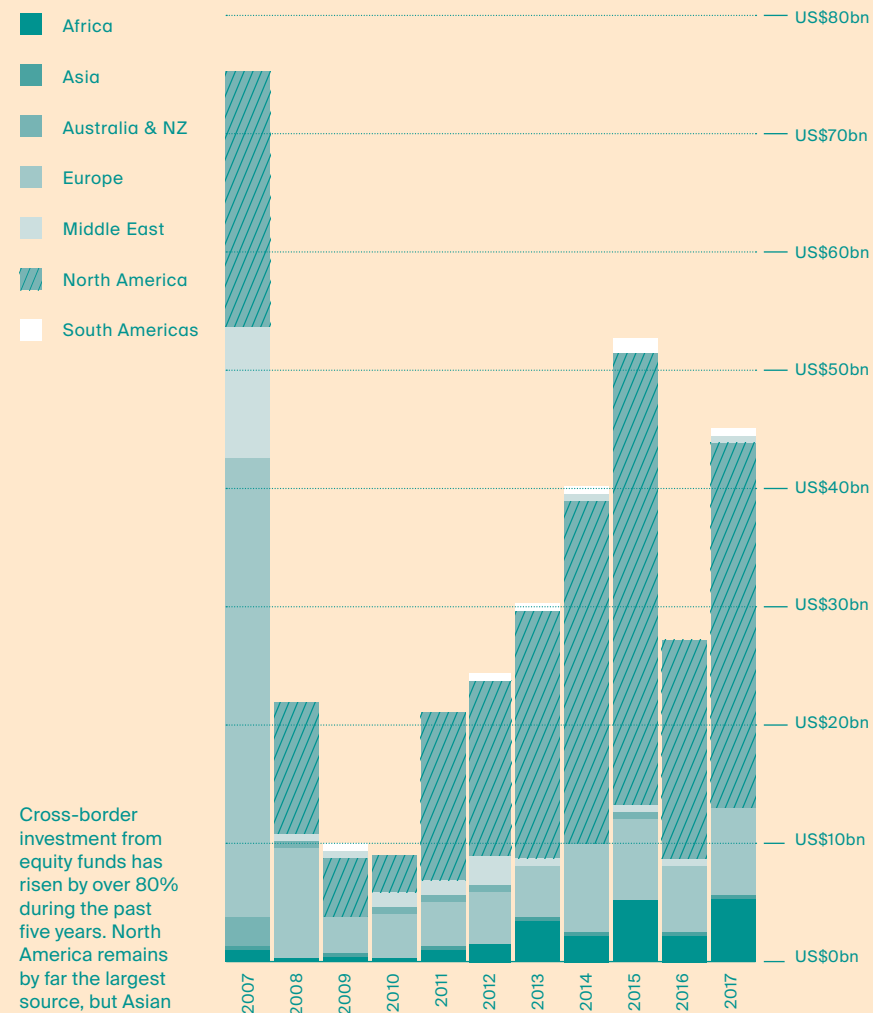
We expect this share to remain elevated, as North American funds are attracted to healthy returns on European assets and increasingly raising capital to deploy in Asian markets.

**Destination of cross-border capital from equity funds**  
2017

Although the bulk of cross-border capital emanates from the US, in 2017 three-quarters of it was invested in European assets.



**Sources of cross-border capital from equity funds**



Cross-border investment from equity funds has risen by over 80% during the past five years. North America remains by far the largest source, but Asian capital is growing at the fastest pace.

Source: Knight Frank/RCA

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**The largest funds have continued to expand rapidly in size, creating a consolidation effect at one end of the scale, and a long tail of smaller funds at the other.**

The largest funds have continued to expand rapidly in size, creating a consolidation effect at one end of the scale, and a long tail of smaller funds at the other.

According to Preqin, firms that have raised funds of US\$1 billion or more in size since 2013 have secured approximately half the total capital raised in the period, despite representing less than 10% of the number of funds closed. As a result, the market share left over for smaller funds has seen fierce competition for capital.

**WHAT HAS DRIVEN THE SHIFT TO LARGER FUNDS?**

One reason is that since the financial crisis, institutional investors in private equity funds have been more selective, placing a greater emphasis on track record. This has favoured established names over smaller new entrants.

Another reason is that scale brings efficiencies. Raising capital can be a long and sometimes labour-intensive process, and a burden that falls

relatively more heavily on smaller funds with fewer staff. Perhaps most importantly, scale has not imposed a performance penalty.

**THE FUTURE: CHALLENGES OF SCALE**

The trend towards larger funds has further to run and, as if to prove the point, 2018 has begun with a number of record-breaking fund raises. Is the race for scale unique to real estate private equity? No. In fact, the shift is even more pronounced in traditional buy-out private equity. But real estate funds that have raised very large amounts of money nevertheless face a number of challenges.

First and foremost is the need to deploy capital and make a return in relatively short order (funds typically have a five-to seven-year life from close). This means that acquiring many small assets is unlikely to be practical for the biggest funds. Purchases need to be of large individual assets, portfolios or even entire real estate businesses – a trend that has been growing over the past year.

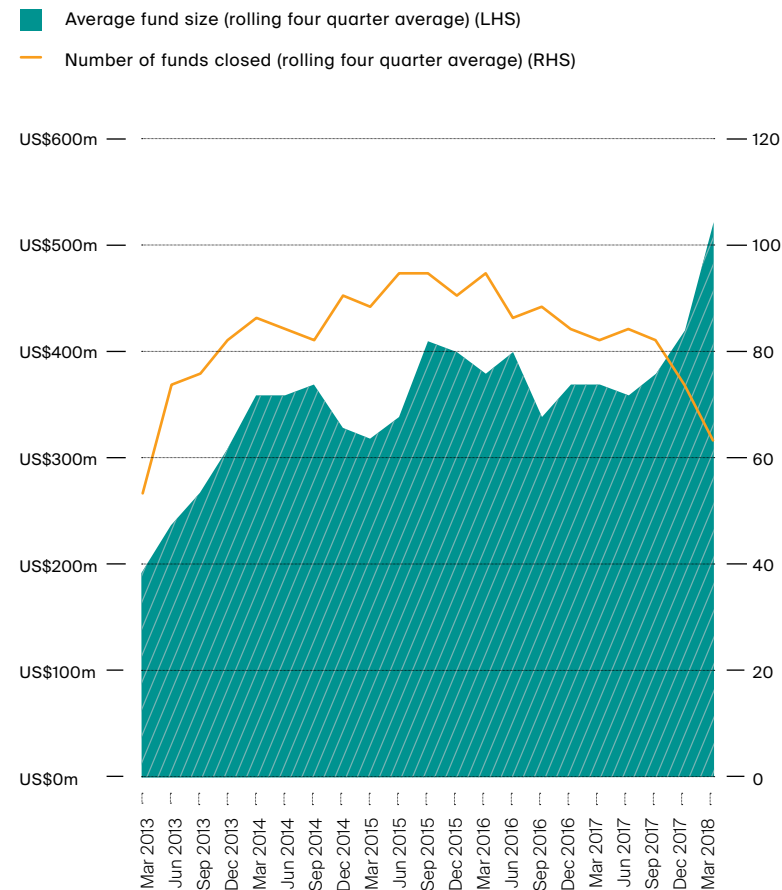
In the longer term, we expect the largest funds to continue to invest along thematic lines, in the same way that some have targeted logistics and residential property to date. These themes will increasingly border on light infrastructure, especially for those seeking a way to enter emerging markets, although the nature of investible stock means that fund purchases will ultimately remain focused on more traditional real estate assets in the medium term.

Indeed, suitable deals have to be sourced first, which is not always straightforward. For example, many specialist property sectors are appealing to private equity funds on paper, but in reality are rendered unviable due to the level of fragmentation in these markets. This is where smaller funds still have a place as product aggregators, especially in niche markets where a particular asset-level expertise is required.

Then there is the risk of sub-optimal deals. An opportunity to deploy capital in significant volumes could be hard to resist, even at the expense of performance. Particularly pertinent in the current market is the danger of overpaying simply to put funds to work, a hazard that private equity investors across all asset classes are alive to at present.

Looking further ahead, the assembly of world-class real estate platforms has clearly been an attractive way to drive returns, but assets must eventually be sold to realise capital. 2017 and 2018 to date have seen numerous examples of billion-dollar platform sales, but it is clear that the larger the entity, the smaller the pool of potential buyers. Nevertheless, we remain sanguine about demand for these businesses. Many of today's most prolific investors – sovereign wealth funds, or Asian capital exporters – were in their infancy just ten years ago. The next decade will see these funds grow in scale, and more importantly, be joined by wealth created from the current global economic expansion and the rising savings of a growing global middle class.

**Capital raising and fund closures**  
for private equity real estate



Source: Preqin/Knight Frank



# Wealth of nations: The impact of the changing order

*The Wealth Report*, published annually by Knight Frank, is the market-leading publication for understanding global wealth trends. These trends drive capital to commercial real estate either through direct asset acquisitions or indirectly through increasing allocations to asset managers. What does the latest report tell us about the quantum, routes and sources of demand for commercial real estate?

Wealth continues to grow at pace. The number of ultra-wealthy individuals with net assets of over US\$50 million rose by 10% last year according to Wealth-X data prepared exclusively for our latest *Wealth Report*. This marks a noticeably stronger rate of expansion than in the previous five years, which recorded a cumulative 18% increase.

#### WHERE WILL THE MONEY COME FROM NEXT?

The next five years is expected to see a continuation of this recent return to growth, with the global population of ultra-wealthy forecast to rise by 40% over the period. This expansion in the population of UHNWIs will continue to be driven by North America, which will remain the world's largest wealth region; here, growth over the next five years is expected to be 38%, taking the population to just under 60,000.

However, Asia is catching up rapidly and the 55% increase expected over the next five years will continue to narrow the gap with the US. Indeed, despite a much-improved rate of growth in Europe last year, the region narrowly lost its second-place position to Asia in 2017. And with China expected to double its population of ultra-wealthy individuals by 2022 and strong growth in Japan (+51%), India (+71%), Indonesia (+66%) and Malaysia (+65%), it will now start to pull away from Europe.

At a country level, the US continues to dominate across all wealth bands, with a particularly significant dominance in the demi-billionaire space (US\$500 million+), with 1,830 individuals versus the nearest closest region, China Mainland, at 490. This dominance will continue as far ahead as 2022, with the US forecast to remain the key driver of global wealth accumulation at 36%

growth overall. However, this may prove to be conservative if the recent changes to corporation tax encourage more investment across the US.

And while Europe has been overtaken by the continued momentum of Asia, the next few years will see a much-improved rate of growth than the previous five years as the economic position improves. Therefore, expect Europe to be a more important part of the capital flows landscape than in the recent past.

#### WHERE IS THIS PRIVATE CAPITAL HEADING?

A key focus of *The Wealth Report* is to identify sources and destinations of private capital. This year, for the first time, the report included analysis of newly released data from the Bank of International Settlements (BIS) on the level of foreign deposits by “non-banks” in their financial institutions.

This provides a unique perspective on the movement of money around the globe and helps us to understand shifting capital flows that are likely to have an influence on real estate markets. In particular, it paints a picture of a very active flow of capital around the world, with foreign non-bank deposits rising by US\$97 billion in the year to June 2017 in the 29 locations that provide detailed reporting.

As has been widely noted in the direct real estate markets, the movement of Chinese capital has been increasing rapidly. This is reflected in the BIS data, with Chinese funds deposited in reporting locations (i.e. outside China) rising by US\$172 billion over the three years to June 2017. Interestingly, the impact of Chinese government policy can also be seen in the data, with Macau recently seeing a decline in deposits (down 10%)

**Growth in number of UHNWIs by 2022**

Source: Wealth-X

**+71%**

India

**+66%**

Indonesia

**+65%**

Malaysia

**+51%**

Japan

“

**The next five years will see the ultra-wealthy population grow by 40%.**

Image:  
Stephen Di Donato





**The continued appetite for moving money and increasing investment cross-border shows no signs of abating. At the same time, governments are increasingly looking to monitor, if not influence, these flows.**

over the 12 months to June 2017, while Hong Kong has become increasingly popular with Chinese investors, up by US\$19.5 billion in the same period.

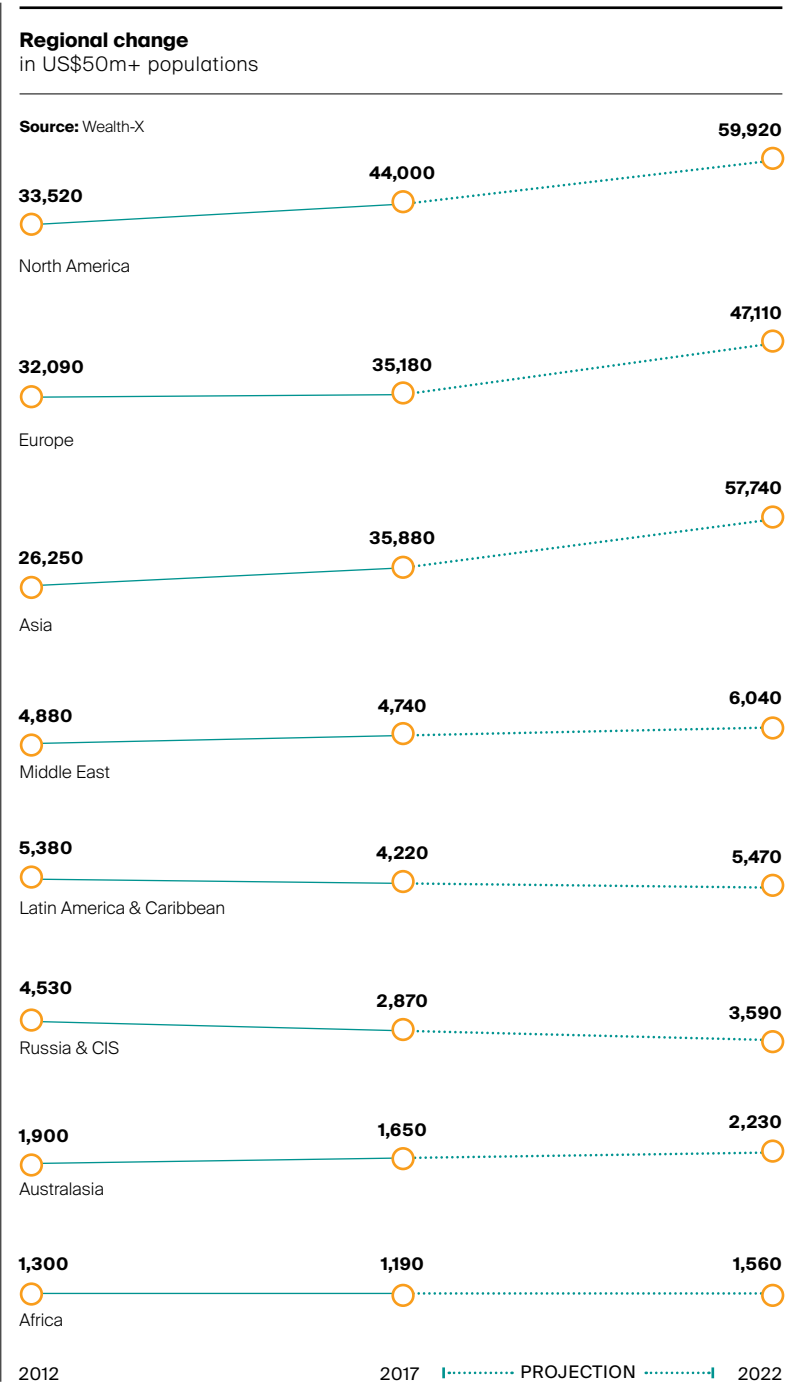
Indeed, the impact of legislation is becoming an increasingly important factor in the global movement of money. The introduction of the OECD-inspired Common Reporting Standard (CRS), launched in September 2017, for example, looks set to be a key influence on global capital flows over the next few years. The BIS data appears to show that countries not signed up to this regulation are attracting significant inflows. In particular the US, a well-recognised global safe haven which has not adopted the CRS, saw non-bank deposits increase by US\$122 billion over the three years ahead of its implementation, with a rise of US\$90 billion in the 12 months to the end of June 2017 alone.

At the same time, commentators point to other traditional low-tax jurisdictions whose attractiveness is being eroded by the CRS and other transparency measures. Bahamian non-bank deposits fell by 25% in the last year for example, while deposits held in the Channel Islands also declined, with a 31% fall in Guernsey.

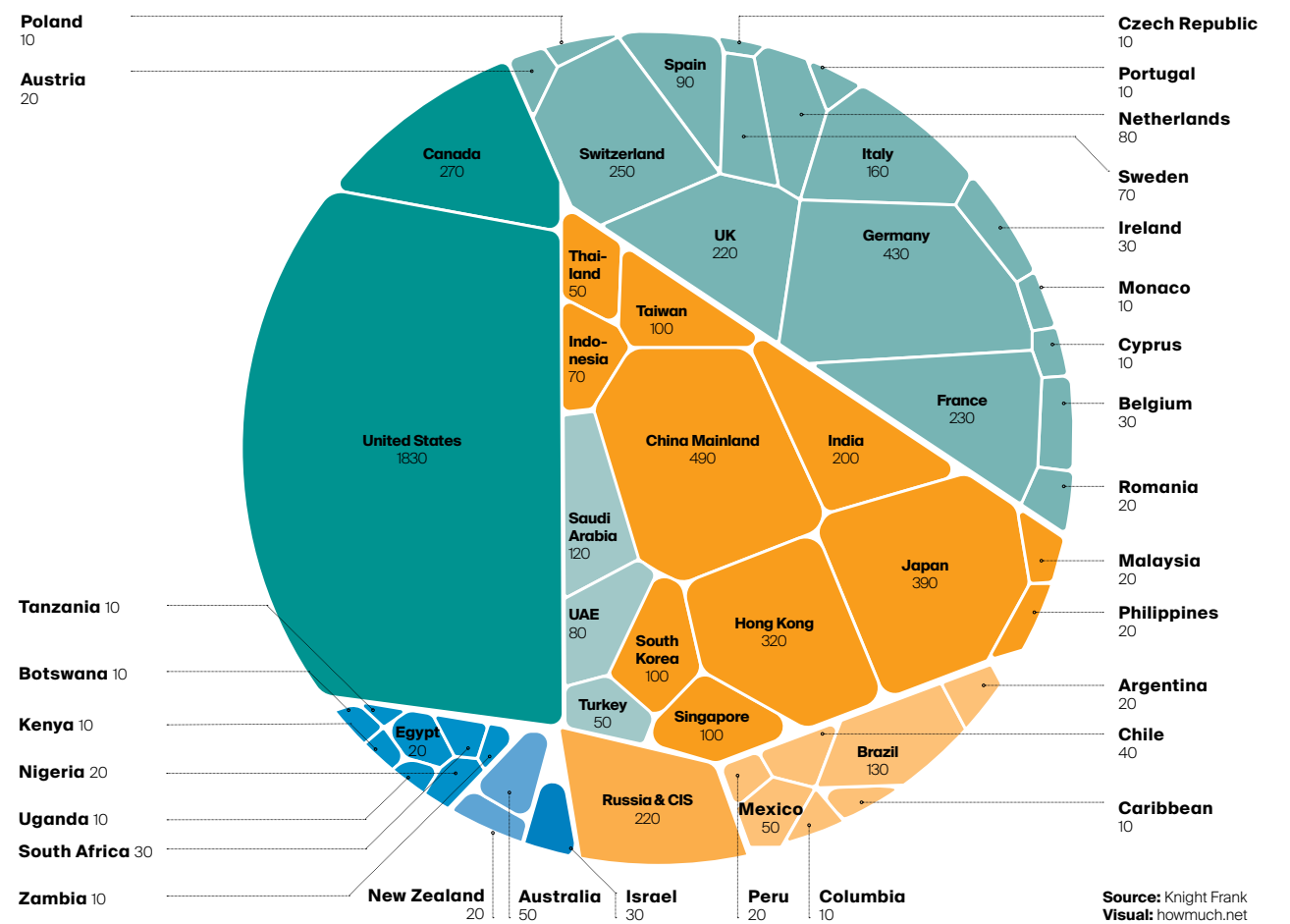
**GROWING COMPLEXITY**

The continued appetite for moving money and increasing investment cross-border shows no signs of abating. At the same time, governments are increasingly looking to monitor, if not influence, these flows. As well as the requirement for investment diversification, as investors become fully exposed to their local markets, there is an increasing number of regulatory reasons for this capital to move.

These include: the impact of capital controls on money movements out of countries such as China and India; the taxes on foreign buyers increasingly being implemented in a number of jurisdictions; the drive for more transparency by governments; and the attractiveness to some nationalities of swapping foreign direct investment in return for citizenship. Add in a push for more global tax revenue to be “on-shored” rather than held outside domestic tax regimes, plus the possibility of trade wars, and we expect capital to continue to move around the world at speed.



**The ultra-wealthy by country**  
Number of individuals worth US\$500m+ in 2017



**FUTURE TRENDS IN CAPITAL MOVEMENTS**

This strong rate of wealth creation and accumulation will drive increasing demand for real estate investments through both direct asset purchases and also indirectly via deposits in pension funds, insurance vehicles and savings products.

Indeed, as we discuss in our article on so-called megafunds (see page 18), the strong growth in wealth accumulation plus the increasing ability of the asset management industry to capture a share of this growth is driving significant increases in assets under management and a rising requirement for real estate as part of these funds.

Over the next year we expect to see:

- **Increasing attractiveness of the US**  
Strong local wealth accumulation will support domestic demand for real estate and more of this capital may stay on-shore over the next few years. In addition, the BIS data shows just how attractive the US is currently to global depositors. We expect further increases in inflows from overseas depositors into the US, with positive economic growth and rising interest rates being supported by changes to

the domestic tax regime that could also lead to a rise in foreign direct investment and, as the incentives for profit shifting are changed, more capital and intellectual property being repatriated that was previously being held offshore.

- **European renaissance**  
Expect the continued resurgence of strong buying activity from private European buyers as wealth growth momentum returns. Over the last year we have noted a new wave of European capital looking to invest outside their traditional markets, including many that are looking overseas for the first time, and expect this trend to gather momentum.

- **Asian expansion**  
Asian buyers continue to make waves on the world stage as wealth is amassed at pace. Capital controls may temper direct real estate buying by Chinese capital, as we have seen in the US in 2017, but the long-term trend remains one of global expansion, and other parts of Asia, such as Japan, Singapore and Malaysia are in expansion mode.



**There's a new wave of European capital looking to invest outside their traditional markets.**





# Take five:

## Asia-Pacific's industrial and logistics markets

Growth in the sector has captivated investors across the world. Demand is particularly high in Asia-Pacific markets, driven by a rapidly evolving mix of factors: here, we take a look at some of the most important.

**Image:**  
Tanjong Pagar Terminal,  
Singapore

Global investment into industrial and logistics property has doubled over the past five years, reaching US\$126 billion, according to data from RCA in 2017. A sector traditionally prized for its stable income has come to see dynamic capital growth, and in some markets logistics facilities now attract lower yields than retail property – almost unthinkable just a few years ago.

This evolution has been driven by exceptionally broad investor appetite for the sector, with demand ranging from private equity vehicles and institutional funds to private individuals and families. Platform and portfolio transactions have become increasingly common among the largest investors, such is the desire to gain exposure to the sector. Indeed, some of the largest real estate transactions of recent years have come via the sale of logistics platforms, with CIC's circa US\$14.5 billion purchase of Blackstone's Logisor business the stand out example.

What is behind this insatiable demand for the sector? In Western markets, a stylised answer would highlight a structural rebalancing taking place, as changing consumer expectations increase retailer demand for modern distribution facilities. The relative scarcity of this stock is one reason why rental growth forecasts are healthy across much of Europe.

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**Some of the largest real estate transactions of recent years have involved logistics platforms.**

Asia-Pacific markets share many of these characteristics too: witness the lightning pace of e-commerce growth forecast until 2025 overleaf. But, as we explore in our five key trends, these locations face an arguably more complex mix of investment drivers, encompassing global trade, manufacturing growth and new infrastructure opportunities to name just a few.



**01**  
**China moving up the value chain**

China's growth over the last 30 years has been largely based on being the workshop of the world, relying on low-cost labour and often heavy manufacturing. However, as crystallised in the "Made in China 2025" industrial strategy launched in 2015, policy makers are making a concerted effort to accelerate the country's move up the value chain. Known as the Chinese version of Germany's "Industrie 4.0", the aim is for China to compete globally in manufacturing innovative technologies. In terms of the impact on the built environment, there will be more investment in high-tech business parks, a continued drive to upgrade existing industrial sites and more investment in modern logistics facilities, while some of the older brownfield manufacturing areas, especially in the country's rust belt, could begin to be targeted in a nascent regeneration strategy. Externally, "Made in China 2025", along with the rising cost of labour is already pushing a number of major international manufacturers into lower-cost locations, especially in South-East Asia.

**02**  
**E-commerce in South-East Asia**

With a challenging fragmented market, a lack of easy online payment methods, and a strong shopping mall culture, e-commerce in South-East Asia has not had the same penetration as some other regions. However, while the story of e-commerce in China, home to the world's largest online retail market, is well documented, the potential in a region of 650 million consumers and a rapidly growing middle class must not be overlooked. The significant investments of the major Chinese e-commerce giants, Alibaba and Tencent, into South-East Asia over recent months have brought the region into sharper focus, and with cross-border payment solutions being introduced, the scope for growth is significant. As with other markets, as more retail moves online, the growth in demand for modern logistics warehousing around major urban centres and transport axes will be a strong trend going forward.

**03**  
**Belt and Road to shift manufacturing and spur logistics markets**

Launched in 2013, China's flagship Belt and Road Initiative is already having an impact on markets across the Eurasian continent. Spanning more than 70 countries in Asia, Africa, the Middle East and Europe, the BRI has directed significant investment into ports, railways, highways, power plants and economic zones to the benefit of destination markets and Chinese contractors.

While the initial investment is focused on infrastructure, the initiative is likely to help encourage the movement of low-cost manufacturing towards parts of South-East Asia

and Africa, while new transport corridors will provide significant opportunities in the logistics sector as supply chains are upgraded.

Varying levels of institutional effectiveness and market risks coupled with the sheer scale of the vision mean that progress will likely be patchy and opportunities staggered, although South-East Asian markets, in particular Thailand, Malaysia and Cambodia, are already seeing an uptick in interest across these sectors amongst Chinese and international manufacturers and real estate developers.

**04**  
**Indian tax changes helping modernise the logistics sector**

The Goods and Services Tax (GST), regarded as the biggest tax reform in the history of independent India, was rolled out in 2017. The long-awaited move has led to the replacement of numerous federal and state taxes and has brought about significant uniformity and certainty in the Indian market. Prior to the GST regime, the same products were sold at different prices across state borders owing to this lack of uniformity in the tax structure. GST has helped eliminate these price differentials and thus created a level playing field.

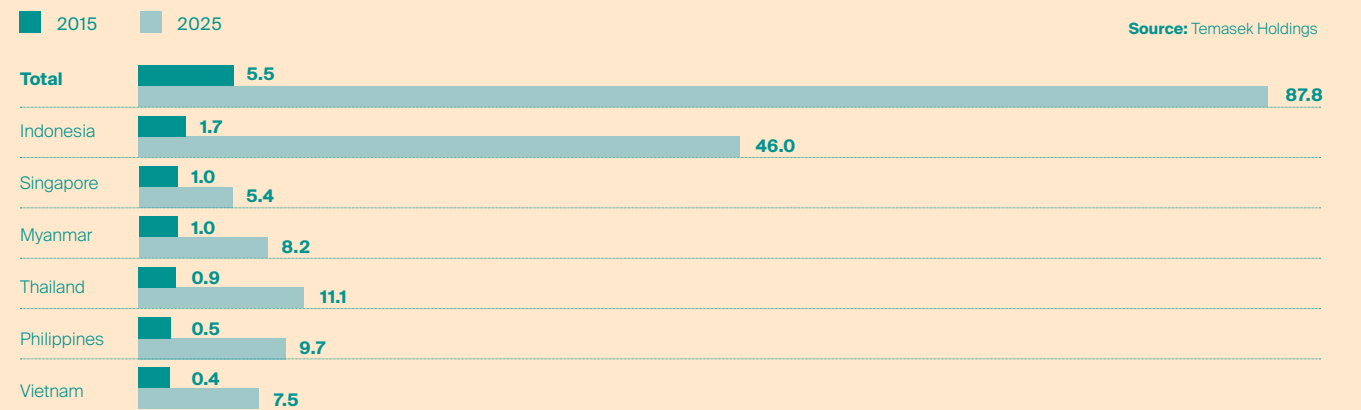
In the logistics and supply chain industry, this is already having a noticeable impact. First, the removal of check-points has led to the faster movement of goods, which is leading to reduced inventory holding levels. Reduced inventory levels directly impact the requirement for warehousing space and facilitate the growth of fewer, larger warehouses that allow companies to leverage enhanced economies of scale. Subsequently, in a very fragmented market, developers and logistics players have started to look at warehouse consolidation. All of these changes are attracting increasing interest from investors keen to tap into growth in the second most populous market in the world.

**05**  
**Trade tensions**

2018 has been marked by fluctuating trade tensions, especially between the US and China. The threat of escalation is forcing some businesses to review their strategies and risk assessment. Major manufacturers who could potentially face increased tariffs if the situation deteriorates could look at adjusting their supply chains, with many already looking at contingencies in case the situation worsens. This could have an impact in a number of ways, with possible reshoring or outsourcing to markets where any potential tariffs could be circumnavigated or assembling components in different markets to reduce risk. While a deteriorating situation could have a knock-on effect on a number of Asia-Pacific economies, political manoeuvring could resolve the situation or potentially see increasing engagement on other multilateral trade deals.

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There is increasing interest in India from investors keen to tap into growth in the second most populous market in the world.

South-East Asia e-commerce market volume 2015-2025, by country (US\$bn)



Source: Temasek Holdings

**US\$88bn**

Forecast size of e-commerce market in the ASEAN region in 2025



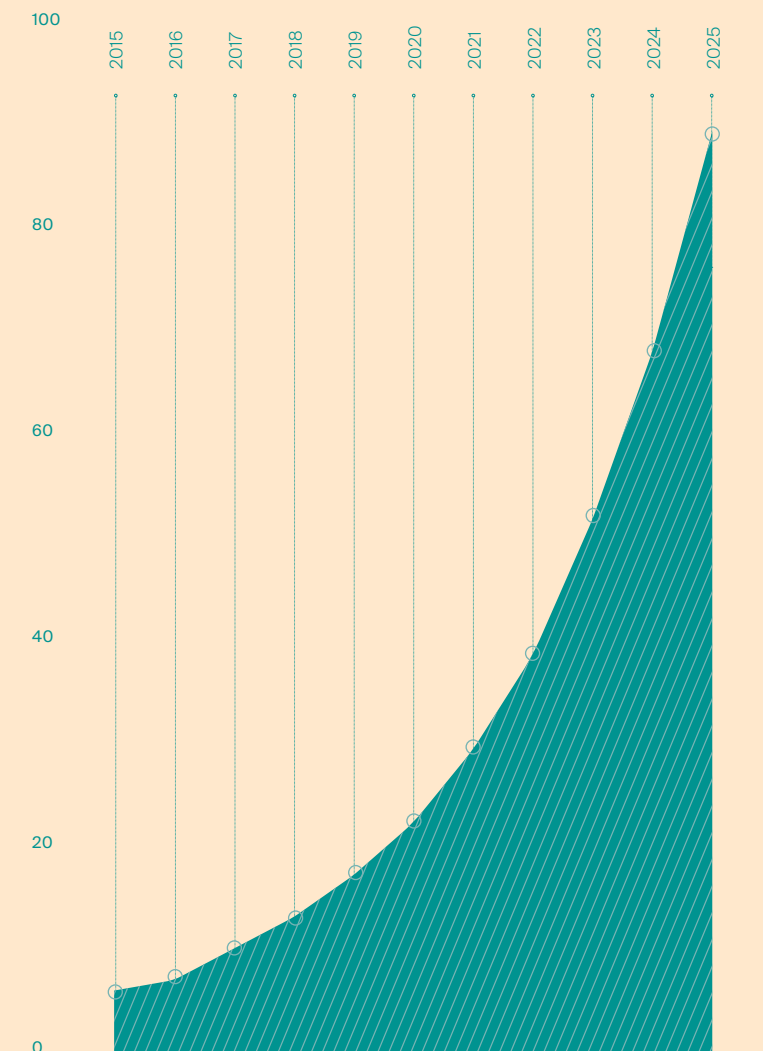
**Amazon logistics in Australia**

Recently, the next phase of Amazon's APAC strategy commenced with its Australian launch, highly anticipated in a market where a vast geography and limited national infrastructure network makes achieving rapid delivery times a challenge.

Historically, Australian vendors were able to sell through Amazon but had to send products offshore for shipping and packaging. Now, a new distribution warehouse just outside Melbourne allows this to be a much more streamlined process.

These are still early days, and the commerce giant is yet to launch its Prime offering – which accounts for 63% of Amazon members in the US – to Australian consumers. Amazon's expansion into other large markets has typically been followed by significant acquisition of logistics space near urban locations, and we expect a similar pattern to be followed in Australia over the next few years.

Forecast size of e-commerce market in the ASEAN region 2015 to 2025 (US\$bn)



Source: Business Insider/BI Intelligence



# Building the world

Growing demand from investors for international properties has been one of the defining features of the world's leading urban housing markets over recent years. And, where investors lead, developers follow.

**Left:**  
One Barangaroo, Crown Residences, Sydney

As real estate investment becomes progressively more global, so does the activity of developers. The strength of this trend is confirmed by the fact that the level of cross-border acquisitions of residential development sites across the world has increased each year since 2014, rising by 26% in 2017 alone.

International developers are playing an increasingly influential role in the world's prime residential markets. In itself, this process is not new – for example, many Hong Kong and Singapore based developers have been operating outside of their domestic markets for decades. However, the volume of activity has changed up a gear with the advent of a new push from developers to target the world's "gateway markets", in particular London, New York, Singapore and Sydney.

In recent years – a leading Indian based developer has focused on London; a Shanghai developer has targeted Los Angeles, New York, London and Sydney; while Malaysian developers have been building in Melbourne, London and Singapore.

While some international developers are buying sites to develop themselves, others are embarking on joint ventures with domestic developers. For example, in London there are active developments by a consortium of UK, Singapore and Malaysian developers.

International businesses are not only active in the development space as sole developers or through joint ventures, but also through the funding of developments. Investment can come from financial institutions (including pension funds, insurance companies and banks), sovereign wealth funds or wealthy individuals.



**Globally, the level of cross-border acquisitions hit its highest level in 2017, having risen by 90% since 2014.**

## THE GLOBAL PICTURE

Cross-border investment is nothing if not volatile. To understand this trend in more detail we have analysed cross-border acquisitions of residential development sites in a selection of key global cities, from each region, over the past four years.

Globally, the level of cross-border acquisitions hit its highest level in 2017, having risen by 90% since 2014. Despite this new global high, and perhaps reflecting their position at the forefront of this trend, cross-border activity in London, New York, Singapore and Sydney has seen volatility in recent years.

This volatility can partially be attributed to slower markets in 2016 and 2017, and also the expansion of cross border development activity into other global cities, such as Los Angeles. At the same time, tighter capital controls in mainland China have led to more scrutiny of potential high-profile investments.

In New York, cross-border acquisitions have declined over the past two years. However, in the wake of tax reforms at the end of 2017, the attractiveness of New York to international developers has risen and we expect activity to start to pick up again.

Activity in London has swung between two extremes. In 2015 it was the only market to see a year-on-year decline in cross-border acquisitions, with a fall of 26%. However, in 2017 cross-border acquisitions increased 82% to a new peak. We expect this trend to continue with a significant volume of activity seen in the first quarter of 2018.

In Sydney, it appears that the recently imposed restrictions on foreign buyers, which limit the ability of overseas developers to effectively market projects in their home countries, have started to take hold, with acquisitions falling 83% between 2016 and 2017.

Singapore has recently seen a surge in activity as year-on-year cross-border acquisitions increased by 204% in 2017. This could be attributed to the housing market's recent resurgence following the cooling measures that were introduced by the government four years ago. This trend is set to continue: in the first quarter of 2018, cross-border activity in Singapore equated to almost two-thirds of the 2017 total.

## TOP PLAYERS

Not only are overseas developers active in these markets; they have become some of the cities' biggest players.

Despite the declines in activity noted above, overseas developers have maintained a tight grip in Sydney. Of the top 20 players in the city's residential development sector, over half were international, with YMCI (China) leading the charge. There were a further nine Chinese entities – four of them in the top ten – and one



Japanese. Looking ahead, the prominence of overseas investors is likely to continue, with the recent purchase by Yuhu Group of two Australian projects from Wanda Group, another Chinese developer, for a reported A\$1.13 billion.

The London market has the second highest presence of international developers and the most diverse mix, with Chinese, Hong Kong, Singaporean and US firms all represented in the top 20. Together, these international developers occupy seven of the top 20 slots, including the first and second positions.

The less global nature of the market in New York and Singapore is reflected in the data with, respectively, only 25% and 15% of the top 20 players in these cities being international.

**UNDER CONSTRUCTION**

It is one thing to understand where developers are buying sites, but how many of these are being developed out and sold? We examined data from the beginning of 2017 and the beginning of 2018 to understand how many large-scale developments were being constructed or sold by international entities.<sup>1</sup>

The data show us that London has the highest proportion of under-construction or unsold developments by international entities. At the end of 2017, 41% of large developments in central London were known to be being developed or funded by international means, compared with 31% in 2016, reflecting the growth of cross-border acquisitions of residential development sites.

Developments in central London also had the largest diversity of international developers and investors, with ten nationalities present, echoing the story with site investment. The top nationalities for construction activity were Hong Kong and United Arab Emirates, who were each involved with 15% of the international developments at the end of 2017, growing their shares from 13% a year earlier.

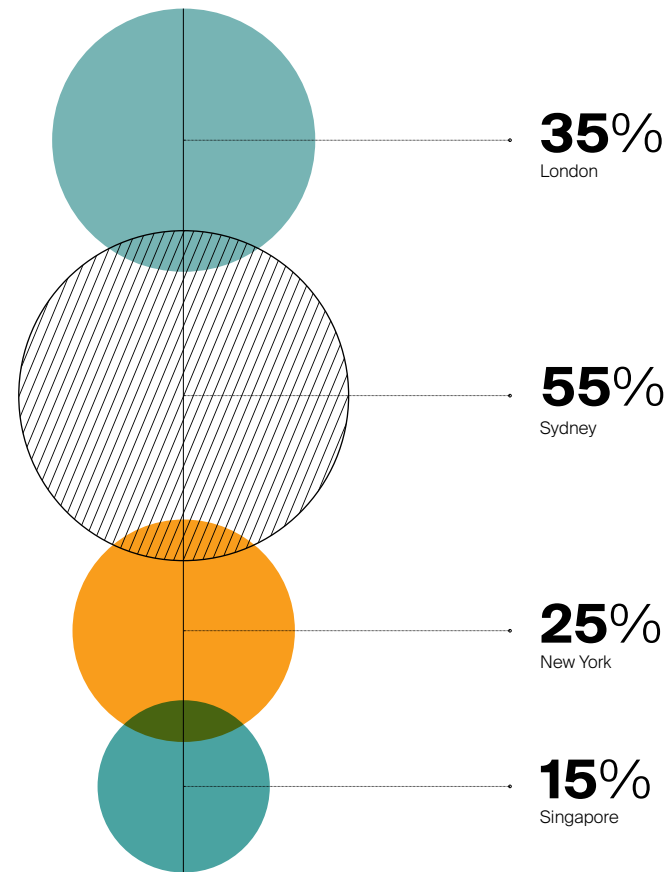
Although cross-border investment in residential development sites in Sydney has decreased in the past year, the proportion of schemes by international developers has increased. Between the beginning of 2017 and the beginning of 2018 the proportion rose from 15% of developments to 20%.

New York tells a similar story. Here, the proportion of projects by international developers increased even though cross-border investment in residential development sites decreased. In the primary development area of Manhattan, international developers were involved with 8.5% of large developments in Q1 2017, yet by the beginning of 2018 this had risen to 11.5%.

The most prominent international developer nationality for both Sydney and New York is Chinese, followed by Singaporean. In New York, Chinese developers were involved, either solely or through joint ventures, in 56% of international developer projects at the beginning of 2018. For Sydney, the proportion is much higher at 83%.

**Top players**

The proportion of the top 20 developers that are international



Source: Knight Frank/RCA

**PUSH AND PULL**

Some of the main push factors driving this growth in global developments relate to domestic market conditions. In Singapore, for example, the market is relatively small so to generate increased growth and returns Singaporean developers and funds have had to look elsewhere.

Meanwhile, many of the biggest players are responding to appetite from consumers in their home markets for international property.

For developers, overseas projects can also offer a level of diversification, in locations that may benefit from clearer ownership laws and rights than those available in some emerging markets.

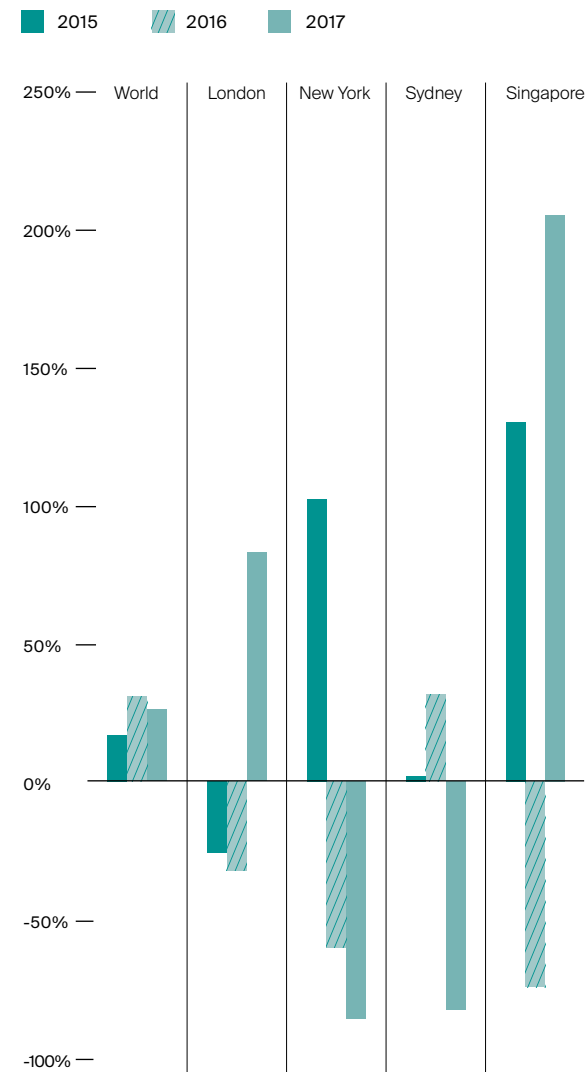
If developers can break into and thrive in prestigious markets then this gives them not only the status of a truly global brand, but yields opportunities to further their reach in new markets and sectors.

Developers can also use joint ventures in different markets to learn new processes and understand how big domestic developers operate.

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At the end of 2017, 41% of large developments in central London were being developed or funded by international means, compared with 31% in 2016.

<sup>1</sup> While the data we have gathered represents a significant amount of development activity, therefore demonstrating broader trends, we were unable to gather full data on the exact level of development being funded by international investors companies. According to industry experts, if this were to be included, the development activity reliant on international sources would be much higher.

**Cross-border acquisitions of residential development sites**  
Annual percentage change



Source: Knight Frank/RCA

<sup>2</sup> Booth, R. 2017. Foreign investors snapping up London homes suitable for first-time buyers. The Guardian

This knowledge helps to increase the quality of their developments and to leverage capital markets rather than just bank loans. This is a particular driver for mainland Chinese developers who can now take these lessons into China where consumers are becoming more sophisticated in terms of their property requirements, prompting large-scale regeneration in certain locations.

**POSITIVE THINKING**

Cross-border acquisitions and developments are becoming more and more important in the global development space. Globally, activity is increasing but, as we have seen, there can be considerable volatility within individual markets. As overseas developers and institutions establish themselves in key gateway cities they are investing further afield into other markets.

This growing globalisation of developments has been an important factor in helping to support supply in many cities, keeping markets buoyant and injecting funds into domestic developers when needed.

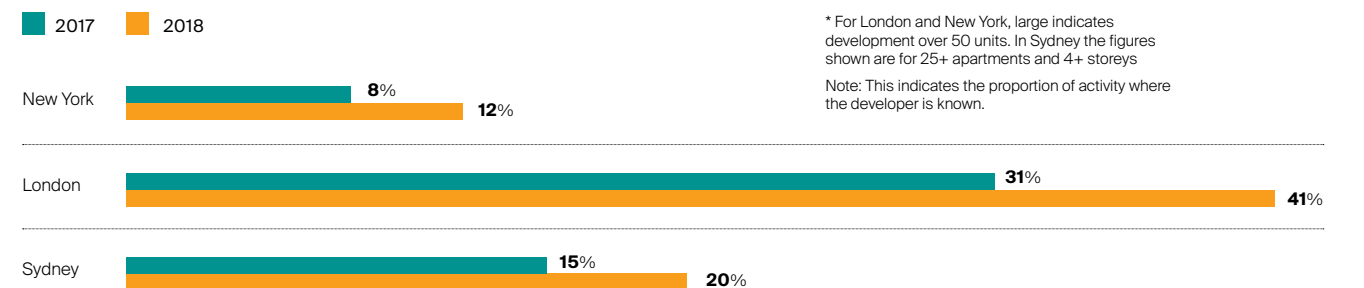
This has been particularly evident in London, where mayor Sadiq Khan has said “international investment plays a vital role in providing developers with the certainty and finance they need to increase the supply of homes and infrastructure for Londoners”.<sup>2</sup>

To date, this has not been the case in Australia; but it could be set to become a more significant factor in the future supply of housing as tighter funding constraints, which came into full force in 2015, have meant that many local developers struggle to obtain finance.

Finally, the increasing presence of international developers in key markets has not only meant that they can learn new practices to take to other markets, but also means there is opportunity for them to share new techniques, different ideas and expertise. This confluence of ideas can help to broaden the variety of stock, as well as having the potential to improve productivity in the development sphere.

**Under construction**

Proportion of large\* developments that are knowingly being developed or funded by international entities



Source: Knight Frank, Douglas Elliman, Mollor

\* For London and New York, large indicates development over 50 units. In Sydney the figures shown are for 25+ apartments and 4+ storeys  
Note: This indicates the proportion of activity where the developer is known.





# Strategic direction

How do we see the outlook for global real estate evolving, and what are the themes that will underpin the market in the longer term?

As we discuss in *The environment for global investment* (pages 36 – 37), the macroeconomic backdrop is at the early stages of significant change across many fronts: the recovery begins to approach its zenith in much of the world; money markets react to the end of a 40-year decline in interest rates; and central banks gradually move to unwind balance sheets.

Politics, sometimes regarded as a sideshow by economists, is proving to be anything but for real estate, with taxation, anti-corruption measures and state diktats just some of the levers being used to redirect the global flow of real estate capital, whether intentionally or not.

More positively, newfound stability in some of the world's largest economies combined with the long anticipated rise of the emerging middle classes is set to unlock huge demand for pensions and insurance products, with a corresponding need to invest the savings thus accrued. Meanwhile, the equivalent vehicles in developed markets are continuing a structural reweighting towards real estate, and recent volatility spikes in equity and bond markets are likely to have strengthened their resolve.

**Left:**  
Shibuya Crossing, Tokyo

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**As the real estate cycle extends, some investors are choosing to move up the risk curve in search of return.**



## 01

**Cross-border activity will continue to increase**

Our view is that, in the short term, the overall volume of global real estate investment will continue to fluctuate within the relatively narrow range seen over the past three years, with around US\$1 trillion representing the recent high point. This is somewhat lower than the peak volumes recorded prior to the global financial crisis. However, the more interesting point is that the proportion of this total that relates to cross-border activity is rising. What's more, we expect this trend to continue for a number of reasons:

- As the real estate cycle extends, some investors are choosing to move up the risk curve in search of return and for some, this entails looking beyond the confines of their domestic markets.
- Many of the sovereign wealth funds and much of the emerging private wealth are being created in locations without a deep or transparent local real estate market, making overseas investment the only practical option.
- While much of the world's real estate remains uninvestible even in mature economies, liquidity is being enhanced by the likes of private equity funds and listed real estate investment trusts (REITs), which assemble, manage and ultimately resell assets or portfolios.

So, where will this investment be directed? It's no secret that a significant share of cross-border capital to date has been focused on continental European markets, and we do not expect this to change fundamentally in the short term. Despite rising pricing, the combination of healthy rental growth prospects underpinned by economic stability will remain attractive to investors. Indeed, our gravity model (page 13) suggests that the fundamentals of some of the largest European markets warrant additional cross-border inflows.

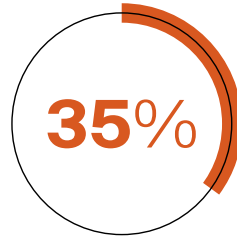
Nevertheless, some of the most rapid growth in inflows continues to be found in emerging real estate markets. Again, our gravity model predicts potential for additional investment in fast-growing markets in emerging Asia, as well as middle income regions of south and central America.

## 02

**Demanding investors**

Institutional investors with long-term liabilities will remain one of the key forces in global real estate investment, with INREV's capital raising survey indicating that global pension funds accounted for over 35% of capital raised for non-listed funds in 2017, followed by insurance companies with 13.2%.

Whether investing directly through their own real estate funds and vehicles, or indirectly via third



**INREV's capital raising survey indicates that global pension funds accounted for over 35% of capital raised for non-listed funds in 2017, followed by insurance companies with 13.2%.**

parties such as private equity funds, their pursuit of performance in order to make up the ground lost following the global financial crisis remains undiminished. In the longer term, we expect institutions to continue to gradually ratchet up allocations towards real estate, not only in light of the strength of recent returns, but also with a view towards cautious capital preservation.

Indeed, another sign of such caution is the proliferation of real estate debt funds. This follows the logic that (as long as loan-to-value ratios are sensible), lending to real estate is less risky than owning it, if there is any question over the direction of pricing. Does this mean that the market is at risk of a return to unhealthy levels of debt provision? Not necessarily. If anything, debt in real estate overall remains less prevalent, especially taking into account the lack of a liquid commercial mortgage-backed securities market in most countries or the reduction in debt held by major REITs. However, among funds at least, the appetite to lend has returned, and ultimately this represents an additional driver of demand.

We expect that the coming years will see the reactivation of mandates from a number of regions with significant investment firepower. The re-emergence of Japan as a major purchaser investor could reinvigorate cross-border trade if even a tiny additional share of domestic investment found its way into overseas markets. Middle Eastern investors, many recently buoyed by oil prices once again returning to profitable levels, are likely to take the opportunity to deploy capital abroad, with the clear objective

Image: Kaique Rocha



Image: Burst

of achieving diversification. Investors in these locations have a long history of acquiring non-domestic real estate, meaning that when they decide to do so again, their focus will not necessarily be on the locations and sectors favoured by first-time investors abroad.

Private wealth will remain a key source of demand for global real estate, growing in scale and becoming increasingly sophisticated and willing to invest beyond core assets in gateway locations.

## 03

**Pricing: a theory of relativity**

With yields reaching record lows in many developed markets, the issue of pricing has become hotter than ever. There is logic to the view that real estate yields are low simply because both central bank interest rates and yields on much larger asset classes, such as bonds, are also low. Applying the same logic in reverse, should rising interest rates therefore indicate rising yields? Ultimately, yes; but the relationship is not so strong that real estate yields will move in lockstep with interest rates or bond yields. For a start, the gap between real estate yields and bond yields remains large enough to offer a significant cushion – bond rates can rise by many tens or even hundreds of basis points before the impact on real estate yields is felt.

The US is a case in point. Of the world's major central banks, the Federal Reserve has gone furthest towards normalising interest rates,

raising the target rate by 150 basis points since the end of 2015, during which time 10-year treasuries have moved from just over 2% to above 3%. Meanwhile, yields on US real estate have remained largely stable.

## 04

**A broader mix of assets in play**

Office and residential property has been the mainstay of cross-border investment over the past decade, but in the longer term we expect that capital will be directed towards a broader mix of real estate. The logistics sector provides the roadmap for this transition: a sector once largely the domain of domestic investors has, with the combination of a compelling demand story and healthy return prospects, become coveted by the world's largest cross-border investors. The catalyst was the creation of portfolios and platforms of significant scale, undertaken by private equity and institutional funds.

Which sectors will the next wave of internationalisation take in? Despite seeing increasing volumes of domestic investment, sectors such as the private rented sector, retirement living, healthcare and student housing currently account for smaller volumes of global cross-border transactions. However, they all offer the key ingredient of structural occupier demand, which ultimately drives return. They will be attractive sectors for investors who can access these markets with sufficient scale, either through platform acquisitions or portfolio creation.



# The environment for global investment

In the last decade, there have been few opportunities for economists to voice genuine optimism on the long-term outlook. However, 2018 has the sense of spring-moving-into-summer about it, with a broadly improving economy around the globe tempting investors to consider more risky strategies.

It would be wrong to assume, though, that there are no clouds on the horizon. In most advanced economies, interest rates are set to rise, although investors can mitigate the impact by targeting higher yielding assets. In short, the risks today are manageable, not systemic – creating an environment that will draw more capital into the market.

### WORLDWIDE RECOVERY

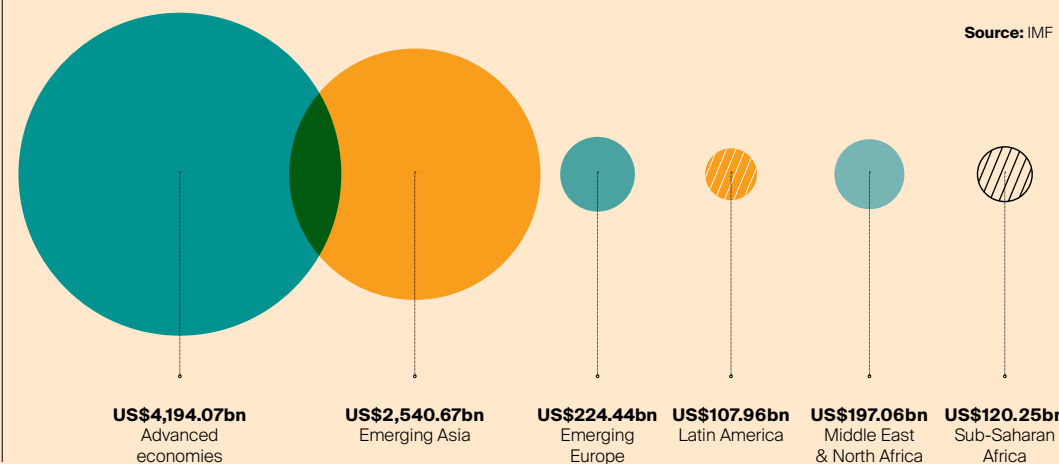
The outlook for the global economy is for robust growth this year, with the IMF predicting that world GDP will increase by 3.9% in 2018, compared with a ten-year average figure of 3.4% (see chart page 37). This is in line with our view that 2017 marked the start of cyclical upturn for the global economy, following a slowdown in 2015/16, when low commodity prices hit emerging markets.

Growth will not, however, be spread evenly as the new cycle is at different stages around the world. Forecasts suggest that we will see huge disparities among different emerging markets. Latin America is predicted to see just 2% growth in 2018, which is less than the 2.5% figure for advanced economies. In contrast, emerging Asia is forecast to record growth of 6.5%, as the likes of China and India continue to modernise. If you arrange the letters according to future growth prospects, rather than the BRICs we should be talking about the ICBRs.

### CHINA AND INDIA

Certainly, there is good reason for an upbeat outlook for emerging Asia. In 2017, India had to negotiate some disruptive forces, such as the withdrawal of certain banknotes and the introduction of the new Goods and Services Tax. Both will have a modernising effect in

Forecast GDP growth in US\$ 2018



“ Investors might also look to cities like London, where the market may be over-estimating the level of political risk.

the long run, but for 2018 there is the promise of less disruption. In China, President Xi has been confirmed in office, while pressure on the renminbi has eased.

Moreover, both nations are making a big impact in the-growing digital economy. In some respects, and in certain regions, China appears to be overtaking the West in the latest wave of e-commerce and mobile apps. Consequently, China and India should provide opportunities for property investors in 2018, although traditionally both markets have been dominated by domestic money.

### ADVANCED OR EMERGING?

However, international property investors will probably remain focused on advanced economies in 2018. Even though the IMF's percentage growth forecast figures for the developed nations are relatively low, it is well to remember this is expansion off a high base. In total dollars, 2.5% GDP growth in the advanced economies is far more money than 6.5% for emerging Asia (see chart on the right).

Also, more Asian money is appearing in the global cross-border property market, and usually it is seeking diversification away from the Asia-Pacific region. The advanced economies also have the attraction of higher levels of market transparency, and free movement of capital.

### RATES ON THE RISE

However, the changing rate environment in the advanced economies might encourage investors to ask themselves: should we buy prime or create it, via development or asset management? Stock markets corrected and bond yields rose in early 2018 as investors acknowledged that the era of exceptionally loose monetary policy is ending. The US ten-year bond yield began 2018 at 2.5%, but had reached 3% by late April. There is debate as to how quickly central banks will raise rates and to what level, but no one disputes that the long-term trajectory is upwards.

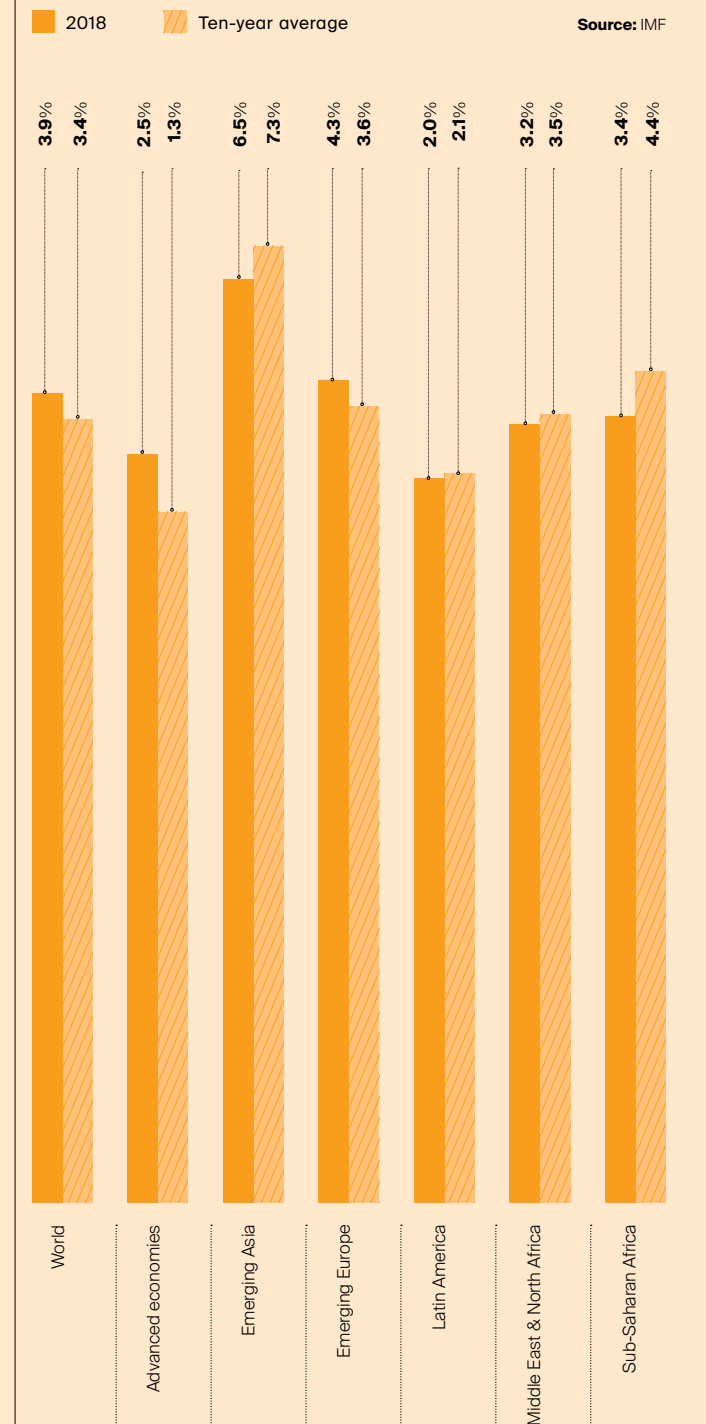
Against such a backdrop investors will probably seek higher returns, and low-yielding assets could now be viewed as less attractive, unless the buyer is seeking wealth preservation. Attention could switch to those cities with a track record of delivering rental growth, with investors perhaps favouring multi-let buildings with a spread of upcoming lease expiries, thus offering exposure to the rental cycle. Investors might also look to cities such as London, where the market may be over-estimating the level of political risk.

In summary, 2018 is a year when the global economy is on course to deliver robust growth, and this will require investors to be more proactive in their strategies. The ride-the-yield-compression period is now behind us as rates start to rise, and investors need to experiment with new markets, different locations, and develop with an eye on new occupier trends such as flexibility. The economy will deliver opportunities going forward, but investors need to go looking for them.

“

The economy will deliver opportunities going forward, but investors need to go looking for them.

Forecast GDP (%) growth vs. ten-year average





# Risk radar

Knight Frank's Chief Economist highlights the key risks facing the global economy and the property market in 2018 and beyond.

By the standards of recent years, the risks currently facing the economy and property investors feel relatively moderate. However, this should not lull anyone into a false sense of security. Risks remain, and while some grab headlines others keep a lower profile. Here is our selection of the key risks we believe investors should be monitoring this year, scored on a scale of one to five for both impact and likelihood, with five being highest in both cases.

“

**Some commentators say that the Federal Reserve and the Bank of England are guiding hawkish but acting dovish, thus using expectations to deter excessive borrowing.**



## Interest rates

Impact 2.0 | Likelihood 4.5

Leading economies such as the US, Canada and the UK have already begun raising their policy interest rates, while debate is ongoing over when the euro zone will end its quantitative easing programme. Bond yields for advanced nations are trending higher in anticipation of a higher rate environment – in early May, the Canadian ten-year bond yield reached 2.4%, up from 1.5% a year earlier. Few would dispute that the era of ultra-low interest rates is coming to an end.

However, central banks have indicated that they intend to raise rates gradually, not abruptly. Also, some commentators say that the Federal Reserve and the Bank of England are guiding hawkish but acting dovish, thus using expectations to deter excessive borrowing. Moreover, across global real estate markets, property yields are offering a significant spread over government bonds, which should absorb some of the impact of future rate increases.



## The disruptors are disrupted

Impact 2.5 | Likelihood 3.5

The US technology sector likes to talk about disruption; however, there are signs that they may be about to be on the receiving end. China is seeing major cities pivoting from manufacturing to hi-tech, while its people have embraced digital apps. Up until now, US tech firms have led the digital revolution, but Chinese firms are now arriving in the West. Silicon Valley's giants face this new wave of overseas competition just as public criticism is growing on issues like privacy and tax.

In the long term, this pressure on the tech establishment will be healthy, as competition leads to innovation. However, in 2018/19 we could see US tech firms, which in recent years have been a major source of global demand for offices and warehouses, reviewing their operations. Time will tell whether new demand from young Chinese tech firms arriving in the West will outweigh any cuts from the US firms.



## Trade barriers

Impact 4.0 | Likelihood 2.0

The threat of protectionism is on the rise in the global economy, which could mean higher costs for businesses, reduced cross-border investment, and exchange rate volatility. Over 30 countries who currently trade with the UK via EU free trade agreements will have to agree interim arrangements as a result of Brexit. This would be overshadowed by the disruption to the UK and the EU were there to be a hard Brexit. The US government's recent tariffs on Chinese goods have, unsurprisingly, prompted retaliation.

Progress has been made towards a transition period for UK/EU trade after Brexit. This may suggest there are signs of compromise emerging, although the situation remains highly fluid and politically charged.



## Labour shortages

Impact 3.0 | Likelihood 4.0

In the aftermath of the Brexit vote, there was a widespread expectation that the UK would see mass job losses. In fact, the unemployment rate has fallen to a 43-year low of 4.2% since the referendum, and there are concerns that Brexit will lead to labour shortages across the skill levels. In other major economies, companies face similar problems recruiting staff. At the time of writing, the unemployment rate is 4.1% in the US, 3.9% in China, 3.5% in Germany and 2.5% in Japan.

The risk for the global economy is that firms will struggle to recruit, which could act as a brake on growth. We see firms responding to labour shortages with greater automation, although in the short term there could be upside for property as firms seek better-quality and well-located offices to increase staff retention.



DEBT FREE & INDEPENDENT

**\$725M**  
WORLD TURNOVER  
(EXCLUDING THE AMERICAS)

**418 OFFICES**

60 TERRITORIES  
15,020 PEOPLE

**The Americas**

**15 Territories**

Argentina / Brazil  
Canada / Chile / Colombia  
Costa Rica / Dominican Republic  
Mexico / Peru / Puerto Rico  
The Caribbean (4) / USA

169  
OFFICES  
5,475  
PEOPLE

**United Kingdom**

85  
OFFICES  
2,145  
PEOPLE

**Continental Europe**

**16 Territories**

Austria / Belgium / Cyprus  
Czech Republic / France  
Germany / Ireland / Italy  
Monaco / The Netherlands  
Poland / Portugal / Romania  
Russia / Spain / Switzerland

80  
OFFICES  
1,035  
PEOPLE

3  
OFFICES  
50  
PEOPLE

23  
OFFICES  
700  
PEOPLE

58  
OFFICES  
5,615  
PEOPLE

**Africa**

**10 Territories**

Botswana / Kenya / Malawi  
Nigeria / Rwanda  
South Africa / Tanzania  
Uganda / Zambia / Zimbabwe

**The Middle East**

**2 Territories**

The Kingdom of Saudi Arabia  
The United Arab Emirates

**Asia-Pacific**

**14 Territories**

Australia / Cambodia / China  
Hong Kong / India / Indonesia  
Japan / Malaysia  
New Zealand / Philippines  
Singapore / South Korea  
Taiwan / Thailand

**KNIGHT FRANK  
TRANSACTION SUMMARY**

	US\$	£	€
Land and buildings valued	1,418 billion	940 billion	1,284 billion
Commercial sales and purchases	76 billion	50 billion	69 billion
Residential sales and purchases	16 billion	10 billion	14 billion
	Sq M	Sq Ft	
Commercial space let and acquired	68 million	729 million	
Commercial space being marketed at the year end	36 million	384 million	
Total space managed	73 million	786 million	

Currency conversion as at 31 March 2017



# Global Capital Markets Board

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