February 2017

Real Estate Strategies

European Value Added Strategies: "Value investing" applied to real estate

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Welcome to the latest edition of Real Estate Strategies:

Executive Summary

- Value added strategies aim to generate higher risk-adjusted returns by applying active real estate strategies; they encompass investments in buildings with the need for leasing up of vacancies, refurbishments, repositioning, or investing in development and redevelopment projects.
- We believe that a successful real estate investment manager needs to consistently apply a "value investing" approach - similar to the one known for stocks and bonds based on the legacy of Graham and Dodd from the 1930s - but specifically implemented in a real estate context.
- The key is to focus on markets with compelling valuations and a supportive rental market environment. This needs to be combined with an ability to source assets with an embedded potential and successfully execute the business plans with asset management and construction teams.
- We currently see a favorable environment for selected research based European value added themes, which we have categorized on the basis of the dimensions "valuation" and "rental cycle". It would encompass the following elements:
  - Invest in UK regional real estate and apply active asset management strategies. UK regional markets are characterized by compelling valuations; Brexit risks are counterbalanced by a low new supply pipeline in many selected locations as well as a low level of GBP
  - Benefit from the persistent rental recovery and low supply in Germany by investing in buildings with vacancies, repositioning needs or development projects
  - Diversify the portfolio further with Dutch offices, Spanish or Irish retail, office outside the CBDs or logistics assets, or selective investments in Central and Eastern Europe.
  - Avoid Paris, London, Italy and Portugal for now but be prepared to benefit from the optionality of political risks down the road. Should some of the political downside risks materialize, be ready to deploy capital at lower valuations in those markets

“Value Investing” in Real Estate

Investors are familiar with the approach of “value investing” in stocks and bonds. This investment philosophy was established by Benjamin Graham and David Dodd in their legendary textbook “Security Analysis” published in 1934 and is also applied by famous and successful investors such as Warren Buffett. This principle aims to find assets that are underpriced by means of research analysis of company or market fundamentals.

The ability to identify undervalued assets is also related to the question of market efficiency. Under that term we understand the price of an asset to incorporate all current and past public information available. While in asset markets that are nearly efficient, “value investing” has come under question in recent years, the situation of real estate is different. The limited efficiency of real estate markets can be attributed to various factors, such as their limited transparency, the heterogeneous nature of the assets or the inability of investors to go short. As a real estate investment management platform that still manages assets acquired or funds launched as early as 1938, we firmly believe that a “value investing” approach can be consistently and successfully applied to real estate.

Both the difficulty and beauty of real estate lies in the fact that every deal is different. Even before placing a bid on an asset, an investor needs to have a view on its value. He is only able to generate additional value if he is adept at correctly estimating costs and revenues of the building in the future. To do that successfully, therefore, the investor needs to rely on a wide range of different skills, such as macro and micro analysis, deal sourcing, the assessment of rental contracts as well as building engineering expertise.

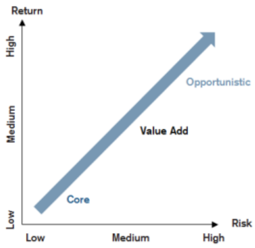
Value investing in real estate is also different compared to its application with financial assets due to the necessity to execute on these asset management strategies foreseen in the business plan. In order to improve cash flows, negotiations with potential tenants need to be successfully concluded or cost controls be applied when doing refurbishments, to name only two examples. The operational aspect cannot be neglected in real estate; that is why active management is required here that can flexibly react to a myriad of factors that might occur and cannot be replicated with passive products.

What Are Value Added Strategies?

Real estate strategies can be classified into three major categories: core, value added and opportunistic, as shown in Figure 1. Core strategies are low-risk strategies, in which returns are mostly derived from rather predictable cash flows due to long-term rental contracts.

Value added strategies, the focus of this paper, aim to achieve higher returns via a stronger emphasis on capital appreciation. There are different ways in which a value added manager can target those higher required returns. On the one hand market selection becomes more important, as he needs to selectively focus on markets with stable or improving values as well as compelling valuations. On the other hand active management, such as leasing up vacant space, repositioning of buildings by means of refurbishments or redevelopments, or ground-up development at established locations can also be typical characteristics of value added assets. In the best case he needs to combine both macro and operational aspects. Leverage can also play a more significant role than in core portfolios, as he can go up to an LTV of 60%. Value added strategies typically have targeted exit dates. So a business plan needs to be executed within a limited time period, typically between four and 10 years.

Figure 1: Real estate strategies



	Core	Value Add	Opportunistic
Risk	Low to average	Average to high	High
Debt Finance	<40%	40%–60%	>70%
Real Estate type and location	Existing properties, well tenanted, central and stable income returns	Existing properties often with the need for refurbishments or re-positioning New developments in Existing locations	Problem properties, development projects, less centrally located or in emerging markets
Holding period	Unlimited	Typically 4–10 years	Typically 3–7 years

Source: Credit Suisse

Value Added Case Study: Querstrasse Transaction

We would like to illustrate how a value added project can be executed by means of an example of our value added funds. In July 2014 a fund purchased an office building in Querstrasse in Frankfurt, Germany.

Frankfurt, Querstrasse building

Source: Credit Suisse

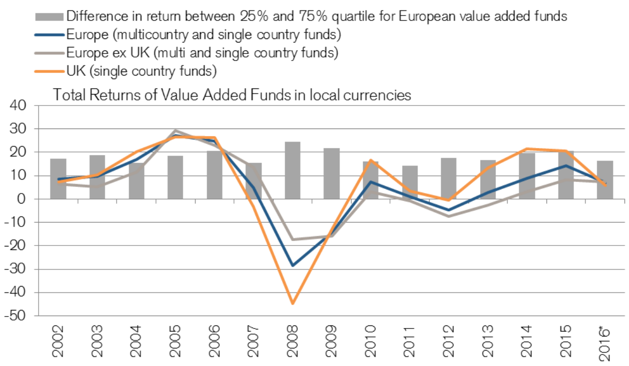
Frankfurt as an office market was being avoided at the time by many real estate investors due to the persistently high vacancy rates and investors were focusing rather on the other Top-7 German cities, such as Hamburg, Munich or Berlin. The micro location and the asset itself were seen as suboptimal by the market, so the building had a vacancy rate of 42% of the total space. The rental contracts in place exhibited short expiry rates, as seen in the WAULT (weighted averaged unexpired leased term) of roughly two years. So the fund was able to acquire the asset at a price per square meter (psm) of approximately EUR 1,900. Even at the lower pricing levels in 2014, this corresponded

to a low price. Based on our analysis of the transactions reported to the Real Capital Analytics database, this was the lowest price paid per square meter within the radius of one mile between January 2013 and December 2014.
These types of circumstances are typical for both “value added” as well as “value investing” opportunities. A situation when assets are avoided by some investors but there is an embedded potential in the asset that provides the opportunity for such an approach.
In order to reposition the building, the fund had to invest EUR 640 psm into refurbishments of the building. Then, vacancy rates have contracted in Frankfurt in line with our expectations. So in less than two years the building could be leased up almost completely with a significantly higher WAULT of over four years for the new rental contracts in place.
With the potential of the building realized earlier than anticipated, the fund exited the property in July 2016 at a substantially higher price and on a leveraged basis the investment has delivered a net IRR of 19.0% p.a. to the investors.

Market Cycles and Vintage Effect in Value Added

Investors, however, need to realize that with “value added” they also invest in a higher risk profile than with core, as the double-digit targeted IRRs do not come without the respective risks.
Figure 2 depicts the total returns based on the reporting of European value added funds to the INREV database. It highlights two main points:

Figure 2: European value added returns since 2002



Source: INREV, Credit Suisse
Last data point: September 2016. 2016 returns point as of Q3 2016
Historical performance indications and financial market scenarios are not reliable indicators of future performance

The first point is the importance of the real estate cycle in value added returns. In Figure 2 we have depicted total returns for European value added funds since 2002 by different regional sets. Even though total returns as a performance metric can be misleading for value added due to typical J-curve and vintage effects in investments, the graph clearly illustrates the impact of the business cycle and economic environment on returns.
Between 2002 and 2006 value added funds saw strong returns due to the positive market environment. Lower vacancy rates, strong rental growth and lower yields were a general characteristic of a market environment which got more and more irrational towards the end of that phase and led in the end to a substantial overvaluation of real estate assets. During the subsequent Great Financial Crisis and the Euro Crisis real estate values corrected sharply. The downside in prices was increased due to a credit crunch and troubles in the financial sector. This market environment resulted in five years of disappointing performance for this segment, in general.
From 2013 on, returns for value added funds started to rebound on a broader basis. However, the markets exhibited strong differences not only between continental European and the UK assets but also between primary and secondary cities in the respective countries. The UK has generally outperformed primarily due to the strong evolution in central London, while the recovery in regional cities was limited. In general, even after two good years for value added, the value appreciation has not been as strong as in the booming pre-crisis years and we believe the market has still some embedded potential, as we are highlighting the opportunities in Europe for value added returns below.

Selectivity and Discipline as the Art of Avoiding Losers

The second highlight from Figure 2 is the differentiation between stronger and weaker funds shown in the interquartile range. Throughout the last 14 years there was a persistently high return differential between the best and the worst performing funds quartile of over 15% p.a., which was even magnified in the down years.
In our view a superior investment performance over the full cycle is determined by the ability of the manager to identify pockets of risks during the good times and avoid those. So the main starting point of value added investing is not about what to buy but what to avoid. We think it is selectivity and bidding discipline that adds the value for the investors. From all the deals we look at, we typically only buy 2%-5%. Many deals drop out as the numbers don’t add up or sellers have too high price expectations. To sum up, we see the following ingredients that can make a value added platform successful:

- ✓ Have a seasoned research platform that is able to identify markets/investment themes to avoid and markets to be invested in
- ✓ Find in those markets assets that are underappreciated by other investors
- ✓ Have an independent risk management department that has oversight over asset management and can say “No” to deals
- ✓ Construct a portfolio of assets that meet the criteria of diversification and there is a “margin of safety” in the portfolio in case unanticipated events occur
- ✓ Have a powerful product/fund manager in full control of the process and able to execute on the foreseen business strategies with asset management/ construction teams on the ground
- ✓ As soon as potential of an asset is reached, exit the asset earlier rather than later

Our High-Conviction Value Added Themes in Europe

Europe has seen an eventful decade with regards to the economic performance, shifts in the political landscape and turns in the real estate markets. Since mid-2013 the economy and real estate market have been recovering, albeit with significant differences between the countries. Due to the QE policies of the ECB, however, income yields for core real estate assets have generally compressed. For value added managers, this means that the low-hanging fruits of just playing a downward shift of yields to generate returns have been reaped. From now on, value added returns need to come from a positive rental market performance and from the manager's ability to find underpriced deals, as well as to execute on asset management strategies.

In Figure 3 we show our recommended value added strategies for Europe according to two dimensions.

Figure 3: Recommended European value-added strategies

Valuation				
■ High yields and high risk premia for core assets ■ High spread for non core assets	■ UK regional malls and retail parks ■ UK regional office markets	■ Regional retail parks and logistics Ireland ■ Logistics and Office Poland and Czech Republic ■ Office regional Dutch markets	■ Residential Spain	
■ Somewhat lower yields but high risk premia for core assets ■ Decent spread for non core assets	■ Retail fringe locations broader London region ■ UK logistics "golden triangle	■ Regional malls/retail parks, decentral offices and logistics Spain ■ Office Amsterdam/ Rotterdam	■ German office market outside of Top-7 ■ Residential Netherlands	■ Retail parks and logistics in Germany
■ Historically low yields but high risk premia for core assets ■ Decent spread for non core				■ CRE and residential in strong micro or macro locations in Germany
	■ Higher vacancy rates ■ Limited rental growth	■ High but declining vacancies expected ■ Positive and improving rental growth	■ Vacancy rates have already declined ■ Rental growth to remain positive	■ Low vacancies and supply outlook ■ Positive sustained rental market recovery at low vacancy rates
	Rental market			

Source: Credit Suisse
Last data point: January 2017

On the vertical scale we distinguish the markets by their valuations. On this dimension we evaluate the markets by two factors. We start by assessing pricing for core deals in those markets on an absolute level and relative to other assets, such as government bonds. Then we evaluate how pricing varies between core and value added deals in the market.

The horizontal dimension refers to the position in the rental cycle. We have categorized markets here into four categories according the current state and our rental market expectations.

Certainly, in the best of all possible worlds investors would prefer to invest in markets that exhibit high yield spreads, low vacancy rates and the outlook for strongly rising rents. Unfortunately, as those three aspects are interlinked and time lags apply, that is not how reality works.

What matters is the combined view of valuations and rental market performance (Please note that categories with high valuation or sharply unattractive rental market situations do not range here because we only focus on those markets which look favorable).

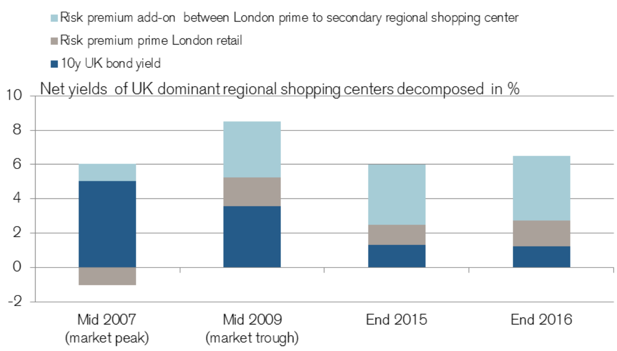
An important point to consider is also that the various investment themes are at a different point in the cycle. Thus, by combining some of those investment themes, an investor can construct a portfolio that is diversified. Diversification means for us a reduction of risks, because different factors are drivers of returns in a diversified portfolio in contrast to when only investing in one niche, in which case the investors might be fully exposed to just one factor.

We do not want to discuss all the markets here in detail, but just pick out some we think are of special interest:

How to Play UK Real Estate in the Light of Brexit?

Brexit was on the mind of many investors in the second half of 2016. The most significant economic impact so far has probably been the substantial depreciation of the GBP vs EUR and USD in 2016 by 14% and 17%. The political uncertainties have so far had a limited effect on the real economy. We expect a solid real GDP growth of 2.1% for the last year, that is likely to slow down to 1.5% in 2017 and 2018. Our assumption is that the UK is heading towards a somewhat messier type of Brexit, which will in the short term weaken the economic activity especially in the London area, while inflation is likely to increase.

Figure 4: High risk premia for UK regional real estate



Source: Credit Suisse, Cushman and Wakefield
Last data point: December 2016

In the mid to longer term we remain positive for the UK as a significant global location for business, especially in the service sector. For now we would however refrain from making value added investments in the central London market. A look at statistics shows, that a large share of the UK's output in the financial services (more than 50%) and telecommunications sectors (more than 40%) is produced in London. We expect that uncertainties of UK-based companies regarding the access to the European single market would reduce space demand in London in the coming years. At the same time office construction activity has been elevated over the last eighteen months leading to our anticipation of an increase of vacancy rates in London.

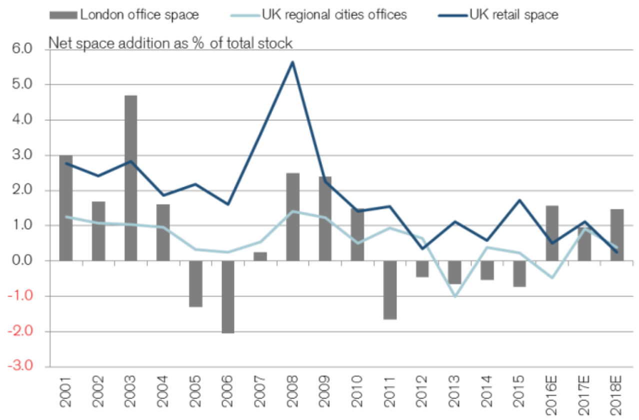
However, we see a significant case for value added investments in many of the regional markets in the UK. Figure 4 demonstrates what we see as a compelling valuation by means of UK retail real estate. For dominant regional shopping centers both the absolute yield spread to bonds as well as the spread to core London assets are on historically high levels. A similar solid research case is also given for office investments in the stronger regional real estate markets, such as Manchester, Glasgow, Bristol, and Leeds.

Investors who are now investing in UK regional real estate are therefore compensated with rather high risk premia, so even the consequences of a harder type of Brexit we think are already priced in. We have decomposed the net unleveraged yields of dominant secondary shopping centers into three components: the risk-free rate proxied by the yield on 10-year government bonds, the risk premia for prime London assets and the add-on premia for UK secondary real estate.

The comparison of the current situation with both the peak in 2007 as well as the bottom of the market provides interesting insights. In 2007 both the London and the UK regional market were significantly overvalued, as seen in the negative risk premia for prime assets and the narrow yield spread of secondary regional assets.

We think that we are currently in a substantially different situation with a yield spread of secondary assets to prime London assets of more than 500 basis points for some regional assets currently offered. Over the last year cap rates for UK regional real estate have increased by 25 basis points, due to the higher stamp duty and the effect of Brexit. What is remarkable is that the core to non-core spread was higher at the end of 2016 than during the depths of the financial crisis in 2009.

Figure 5: Low new supply pipeline in UK regional real estate



Source: Credit Suisse, PMA
Last data point: December 2016

Certainly some investors are worried how demand will fare in regional markets when the economy is in a potentially weaker state. We think that such fears are overblown. On the one side both tenant and investor demand in the regional markets is determined by more domestic players, and multinational companies which could leave the UK are much more focused on the London area. So we expect here a more benign scenario even though some downside risks could materialize.

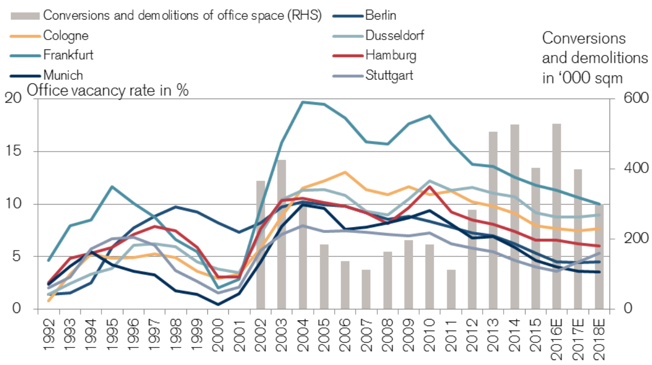
On the other hand the outlook for new supply in the regional market looks on the light side, as highlighted in Figure 5. Putting all these parts together, we believe UK regional real estate offers a favorable environment for the application of value added strategies. The historically weak GBP adds some further appeal to investments in the UK.

Germany: Persistent Rental Market Recovery

The German market is in a different position than the UK regional real estate market. A strong appetite for German core properties has led to a compression of yields, while risk premia are above 300 basis points and still show a relative undervaluation of German property vs bonds. The higher price levels for German properties, however, call for an adjustment of the value added strategy to previous vintage investments.

Value added investors in Germany need to rely in our view on a more active rental market and development strategies to achieve returns. We still think that these can make sense due to the broad contraction of vacancy rates in Germany coupled with a still low construction activity.

Figure 6: Lower office vacancy rates in Germany



Source: Credit Suisse, PMA
Last data point: January 2017

As Figure 6 shows, not only have vacancy rates declined in recent years but also a substantial amount of redundant office space has been taken out of the market for residential redevelopment projects. We are also surprised how little office construction is under way despite the lower vacancy levels. This presents us with a market opportunity.

We think that investors can get exposure to assets with substantially higher vacancies. By means of refurbishments or redevelopments such buildings can be repositioned as core objects. In this market environment we would also consider investing in development projects for office, mixed used or condominiums at established macro and micro locations. Leverage can also play a higher role in German assets compared with other countries due to the better availability of debt capital at more attractive terms.

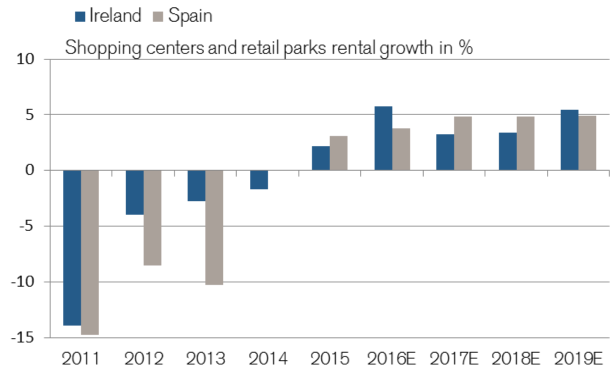
So in all investments in Germany come at a higher risks at this point in cycle but we believe this can be justified by the overall decline of vacancy risks and a situation of healthy demand in Germany. In case of an European crisis German property has also a safe haven function as experienced during the Euro crisis.

Laggards in the Rental Cycle in Europe

In addition to Germany and the UK, the two most significant economies and real estate markets in Europe, we would recommend adding additional investment themes to European value added portfolios. We believe the general macro environment is expected to remain supportive in Europe with a continuing recovery expected in the labor markets. Inflation has seen some signs of revival but the ECB is unlikely to increase interest rates before late 2018; so we believe in continuing supportive monetary policy for real estate assets. We would highlight the following market opportunities:

- **Office market recovery in the Netherlands:**
  The Dutch market has underperformed most core European markets over the last five years due to weak economic growth and an oversupply in the real estate market. Most Dutch cities still face high vacancy rates and effective rents have decreased in recent years, though prime headline office rents have started to improve in Amsterdam. Meanwhile net real estate yields are still higher in the Netherlands than in other core European countries. As a result of this weak situation, we are currently observing historically low construction activity in the Netherlands. We also believe that the economy and labor market should improve further and anticipate solid economic growth of around 1.5%-2.0% for the next two to three years in the Netherlands. This should also pave the way for a recovery for Dutch office space. Value added investors here have the scope to apply active management and buy buildings with vacancies at meaningful valuation levels.
- **Retail malls and parks, offices outside CBD and logistics in Spain and Ireland:**
  The property markets in Spain and Ireland have seen a violent boom and bust cycle with a substantial correction during the Great financial and Euro crises. Office markets and prime retail markets in Madrid, Barcelona and Dublin have, however, staged a spectacular recovery and have outperformed basically all other main European cities over the last two years by a wide margin due to a strong recovery in rents and decline of yields.
  For retail assets outside the main cities, yields have still remained at higher levels and rental markets are in the early stage of their expected recovery. Our forecasts show strong expected returns for the segment of retail malls or retail parks in both countries over the coming years, driven by positive rental growth (see Figure 7); so we recommend investors to get exposure to regional retail centers in these two countries. However here too asset management skills remain crucial and investors need to invest in demographically good macro and micro locations and retail centers with a tenant mix that proves resilient to pressures from online retailing.
  Additionally investors can also invest in selected offices outside the CBD or logistic properties, as those both segments have a similar lag to the evolution to central office and retail space. The focus on micro locations is here key, as there are many decentral locations that don't work especially in Spain.
- **CEE office and logistics:** After having had their fingers burnt before the financial crisis with investment in CEE, which were not only affected by a decline of values but often also by substandard corporate governance in those countries, many investors have avoided investments in Central and Eastern Europe. With stronger economic growth, lighter supply pipelines and still high yields, we believe CEE can also be a driver of value added returns. Many Western European companies still have substantial outsourcing plans to those regions; so investors could not only buy real estate at substantially lower prices and higher yields than in Western Europe but be able to have exposure to the same strong investment grade tenants, if they wish. We, however, would focus on the more transparent countries such as Poland, the Czech Republic and Slovakia in order to limit downside risks.

Figure 7: Anticipated recovery of retail rents in Ireland and Spain



Source: Credit Suisse, PMA;
Last data point: December 2016

How to Address Political Risks in Europe?

As we argued in the section "value investing", risk-adjusted returns are not only driven by the decision of what to buy but also of what to avoid. This also applies to the current situation in Europe, where a focused but at the same time diversified approach is required.

Currently we recommend avoiding value added themes in Paris, London, Italy and Portugal. This relates to the combination of tighter pricing, higher risk-taking in value added and elevated political risks. So while for investors core investments in London or Paris can still make sense, we would avoid them for our value added deals.

Political risks have so far had limited impact on economies and financial markets. But they can be a source of risk as we have seen in the Spanish residential market during 2010-2013 or in some emerging market countries. But at the same time these political risks also involve an optionality that can be exploited in the event that they impact values in the real estate markets.

We see the following topics based on political downside risks:

- **London and a harder type of Brexit:** So far London office transaction prices have only declined by roughly 5% since the Brexit vote in June 2016 and yields increased by 25 bps. The bid for London assets was particularly strong from Chinese buyers while European players have been more cautious. We currently believe that valuations in London do not yet price in the possibility of a harder type of Brexit. This pricing so far is rational, as there are still considerable uncertainties as to how Brexit might impact the London market, and the rental market has not yet seen substantially lower levels of rents in leasing transactions. Should, however, the "clean Brexit" that UK PM Theresa May propagates become reality, we would see some more downside in prices, even though we believe such a period of market weakness might not last for long.

In the case of some more downside over the next two years we would be buyers of London properties, since we clearly believe in the longer term future of London.

- **Italy and Portugal and a rerun of the euro crisis:** Currently we think that real estate yields are too low in these countries considering the higher political risks, the weak balance sheets in the financial sector and the anemic economic growth. In the case of a rerun of the Euro Crisis downward scenario we believe that these two countries would again be most exposed (Spain has reformed considerably and we think the country is currently in a stronger shape). The 2011/2012 Euro Crisis indeed showed that value added real estate projects in Southern Europe are correlated to sovereign risks. In the case of a correction, however, interesting entry points could open up, as some forced sellers could appear. The important point in such a scenario is being able to execute unconventional deals, not only asset or share deals. Typically in such situations investors can enter via the purchase of distressed debt, or mezzanine debt at very low levels of valuations.
- **Paris commercial real estate and French elections:** Net office and retail yields for Paris have come down significantly in recent years and are only slightly above 3%. While we do not have a particularly negative view on Paris office properties, we are also reluctant to take higher vacancy or development risks in France due to the social and structural economic problems in this country as well as the looming elections. So we currently have a "wait and see" approach to French commercial real estate. Should pricing be impacted by the election results in spring 2017 negatively or should we see a more reformist course by a new president in France, we would however adapt our stance.
- **Resilience of selected themes vs the re-emergence of EUR crisis risks:** While we do not see the re-emergence of the euro crisis as a base case scenario, we do believe that the basket of themes we have selected should prove resilient against that risk, as we focus on the stronger economies. The British and German economies are the largest and most resilient in Europe. The GBP is already weak and could prove a hedge vs a weaker euro. German property is also likely to be seen as a safe haven should discussions of a renewed "euro crisis" emerge.

Conclusion

The current environment in Europe remains in our view favorable for value added themes for investors who consistently apply a research-based "value investing approach". Economic growth is likely to continue in Europe, deflationary risks have diminished, while interest rates in the euro zone and the UK are only likely to rise slowly. While prices for core properties have increased, the spreads between core and value added have remained elevated in different regions and segments. In the UK, economic growth is likely to slow down somewhat but the spread between core London and value added projects in regional cities has not decreased much since the depths of the financial crisis in 2009, thus creating a compelling valuation argument in addition to the historically devalued GBP.

The good thing of applying a pan-European approach is also that the position in the valuation as well as rental cycle differs between different countries and segments. So a value added investment manager can construct portfolios that are influenced by different risk factors and reduce risks by means of diversification, while still targeting the higher required returns.

Political risks in Europe also need to be factored into the way to allocate money to the different value added themes, as we have proposed in the previous paragraph; but please bear in mind that a world without risks does not provide the scope of a value approach.

Impressum

Publication Date
February 2017

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