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Real Estate Strategies

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Positive sentiment prevails at the Expo Real

Welcome to the next edition of Real Estate Strategies:

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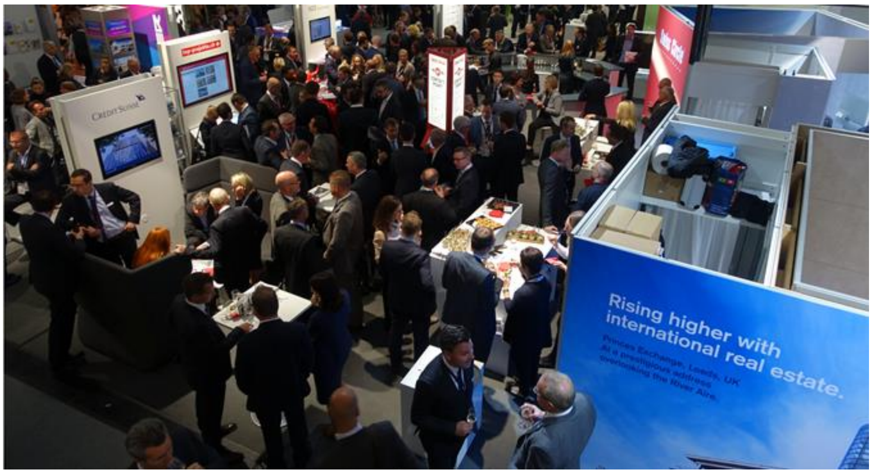


Executive Summary

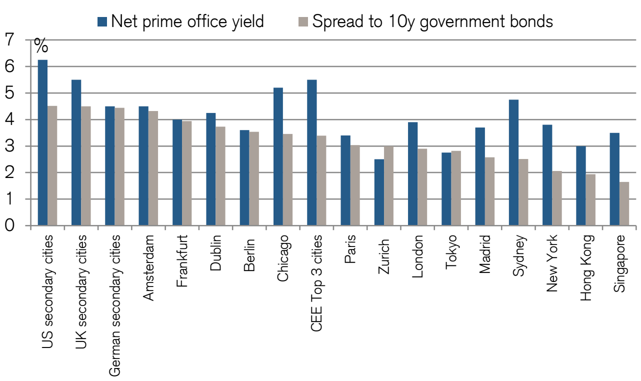
- Credit Suisse Real Estate Investment Management participated in the Expo Real, the largest European trade fair for real estate
- The sentiment at the conference remained constructive towards European and global real estate. While there are some political risks on the horizon, most of the participants expect the benign macro environment for real estate to continue and market evolution to be supported by positive real estate fundamentals.
- Brexit was the most important single topic at the conference. The limited negative impact post-Brexit seemed to have lifted the sentiment towards UK real estate by many brokers and investors. We remain somewhat more cautious than the consensus towards the evolution in London due to the increased probability of a “hard Brexit” in recent weeks. Nevertheless, we see interesting yield opportunities in regional cities as well as opportunities for foreign investors due to the sharply weakened currency.
- German real estate continues to shine. 2016 will likely be a strong year for real estate performance. While yields have come down, we expect the strong evolution in rental markets to continue to support valuations in Germany.
- The US real estate market also remains in a good shape. US real estate provides excellent diversification potential to German and Swiss real estate due to its low correlation with those assets. While we are selective with regards to markets and assets, we see interesting investment opportunities into core/core+ objects with net yields of more than 350 bps over US 10y treasuries.
- Technological disruptions are only slowly making their way into property but several panels discussed the different impacts, such as digitalization, online shopping, crowdfunding, the sharing economy, and big data. We believe that so far technological disruption is moving into real estate via the “Cleantech” channel. That’s why we recommend that investors get exposure to sustainable real estate investment strategies in order to be positioned early on for more pronounced structural changes in this area.

This year's Expo Real Munich, the 19th edition of Europe's largest "international trade fair for property and investment," took place between October 3 and October 6. The conference set a new record with over 39,000 participants from more than 39 countries and 1,798 exhibitors from 29 countries. As one of the best established and longest standing players in this business, Credit Suisse Real Estate Investment Management was also present with a featured stand. With the presence of our senior management and several other senior staff, we can look back on a number of constructive meetings at the Expo.
As this conference typically sets the tone for the dealflow and market evolution over the next weeks, we will briefly highlight our key takeaways from the conference here.

Positive sentiment for real estate prevails

We could distinctly feel the positive breeze that currently pervades our industry, as most participants continue to share an optimism towards European and global real estate. There was a general consensus that the global economy continues to recover, while the limited inflationary pressure prevents any sizeable increase in interest rates in industrial countries. Even as risks, such as a Trump presidency or the currently aggressive ECB policy was critically discussed, most participants seemed to remain constructive for real estate.
The real estate cycle has clearly moved on in many markets and the current strength of the market is also one of the risks going forward, as yields have compressed over recent years. However, the outlook on the rental markets in most Europe, US, Japan, and Australia remains sanguine and is likely to support the further evolution of real estate valuations. The perspective of increasingly negative yielding money market and debt instruments makes real estate one of the few games in town when it comes to yields and distributions to investors. As figure 1 highlights, core European and US real estate provides a yield pick-up of more than 350 basis points compared with government bonds and cash assets and this is still a convincing argument to put money into work in real estate.

Figure 1: Yield spreads are still high for real estate



Source: PMA, Credit Suisse
Last data source: October 2016 (Net yields as of 9/30 2016 and bond yields as of October 12th 2016)
Historical performance indications and financial market scenarios are not reliable indicators of current or future performance

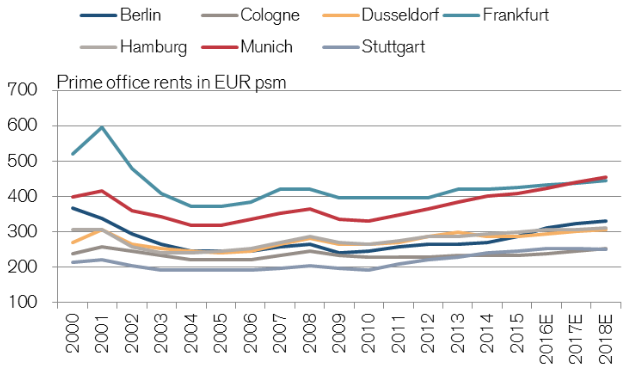
Brexit as most important single topic at the Expo Real

Brexit was the most important single topic, talked about at panels, individual meetings, and touched on at cocktail receptions.
The surprisingly positive economic data and the evolution of the stock markets post-Brexit seemed to have lifted the mood of brokers and investors alike for the UK. We estimate that commercial real estate values in the UK have been dragged down by 5 percent since the vote, while many have expected a more substantial drop. Cap rates probably have seen an upward shift of around 25-50 basis points in London. Most of the retail open-ended funds that were temporarily closed have been reopened.
So these benign effects so far seem to have not only shifted the current sentiment, but have also led many to believe that Brexit will have only a limited effect on UK businesses and real estate.
We do not fully share this optimism as we expect some negative adjustments over the coming quarters to valuations and a substantially weaker evolution in rental markets. We are also somewhat surprised about the resilience of investment and consumer sentiment in the UK. However, when we look at the rhetoric of the EU and UK politicians after the speech of Theresa May in Birmingham, the risks are clearly skewed towards a hard Brexit. While the course of political events can change quickly (we experienced that with the Greek crisis in 2015...) the increasing uncertainty created for foreign institutions in the UK should negatively impact corporate investment sentiment and thus demand for commercial real estate space. In our opinion, this should have a more negative impact on London real estate short term, while we believe in the longer term potential of the city. But investors need to run the numbers deal by deal. Even after accounting for some negative Brexit effects, we see potential for office and retail investments in strong UK regional cities, such as Glasgow, Manchester, Bristol or Leeds. We think investments here currently offer more value and are less impacted by Brexit than the London market.

German real estate in a sweet spot

Germany has always been a traditional focus at the Expo in Munich. This year there seems to be an even stronger bias towards the host country due to the positive evolution of the German economy and property markets. We think German real estate is on course to deliver a strong year in performance in many aspects: Lower yields, substantially lower vacancy rates, and higher rent levels on a broader basis complete a very positive picture with respect to German real estate. We also think that German cities such as Frankfurt and Berlin will be the main beneficiaries if the UK opts for a harder type of "Brexit." In any case, at our meetings, panel discussions supported our positive view towards German real estate. In figure 2 we highlight our recently updated rental forecasts and we believe that the positive momentum on the rental market can be sustained as long as the economy avoids shocks and the construction pipeline remains limited (as it current is).

Figure 2: Further rent increases expected in Germany



Source: PMA, Credit Suisse. Last data source: October 2016
Neither historical nor future performance indications and financial market scenarios are a reliable indicator of current or future performance

Currently, the greatest difficulty in Germany is in pricing and sourcing as there is a tremendous amount of capital chasing German real estate. The advantage of Germany's polycentric structure is that investors don't need to focus only on the top three cities. In order to deliver value to investors, we have opened our focus to include B and C cities in Germany. While those cities have lower liquidity, they offer a yield pick-up to the top cities and in some cities, vacancy rates are lower than in the top cities. However, investors have to be selective and we devote a significant amount of effort to researching the longer-term prospects of regional cities and we apply a very selective approach to investment opportunities.

US real estate provides strong diversification gains to European portfolios

There also seems to be an increasing interest from European players in US real estate, as it was demonstrated by a couple of panels related to the US real estate market at the Expo Real. Many investors see the slowdown in transaction activity this year as a positive event, as it has the prevented the US market from overheating. In our view US real estate is an interesting diversifier to German and Swiss real estate due its low correlation to Swiss and German real estate assets. Also qualitatively it makes sense to add US exposure to the portfolio, as many US cities possess a different mix in the structure of their local economics and tenants compared with the cities in continental Europe. While we are selective with regards to markets and assets, we have been actively screening the market in recent months and have identified several interesting core/core+ investment objects with net yields of over 350 bps over US 10y treasuries.

Technological disruptions in real estate: Slow but be prepared

The current wave of "technological disruptions" has so far only slowly impacted real estate in contrast to other businesses. Nevertheless, we attended several panels on this topic, how digitalization or big data might impact the real estate markets going forward. Technological innovation impacts real estate in many ways and we give some example what we currently see below:

a) **Supply:** The supply is in our view is clearly impacted by the "technological disruption" via the rise of cleantech in real estate. The definition of core building is already impacted by its energy efficiency and we think that in the future all core or premium real estate buildings will need to meet higher standards of energy efficiency. That's why we have been offering investors sustainable real estate investment strategies to get an early entry to this trend, which is likely to accelerate in the future. In the aftermath of Expo Real 2016 a significant innovation in energy efficiency is driven by Credit Suisse Real Estate Investment Management's long-term partner Siemens and SAP. Both leaders in technological disruption recently developed a real estate cockpit that provide an adjustable performance indicator dashboard to achieve a high level of transparency on relevant indicators. As a leading provider of building technologies Siemens[1] is capable of extracting data of each property type and create a fundamental data base with performance benchmarks to optimize a multitude of performance indicators. As a result, this technology disruption leads to a new level of transparency, a prerequisite to optimize building parameter to save natural and financial resources.

b) **Demand:** The trend towards multichannel distribution has also led to shifts in the demand for retail space and to the need for more logistics space. One thing we will probably observe more in the future is more centrally located logistics space, which we have not been accustomed to previously. Sharing platforms such as "Airbnb" have also seen strong growth in recent years. They are not only impacting the hotel business but have led to a shrinking supply of housing, which also creates social problems, as discussed in a controversial panel at the conference. There was the consensus that there is a strong need for regulation here and we will likely see that in coming years.

c) **Data/Research/Analysis:** Databases and a research-based analytical approach have traditionally been neglected by many real estate owners and investment managers in the past. Many players are only now starting

[1] The individual company referenced above is merely for illustrative purpose only and should not be construed as any investment recommendation or solicitation of an offer to buy or sell any securities.

to realize how important consistent data repository systems can be and how much more value a shift to a more analytical and research-based approach in real estate can add. We see a clear trend to more data-driven, research-analysis-based processes in real estate; this will likely become more crucial in the future.

d) **Fundraising:** The use of platforms, benchmarking, and comparison between funds and asset managers is also becoming more important for fundraising. Crowdfunding is also growing in real estate but hasn't yet made the step to become mainstream due to several operational hurdles. It is our view that trust and traditional relationships are likely to dominate fundraising going forward but we continue to keep an eye out on trends in crowdfunding as well.

Impressum

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Publisher:
Ulrich Braun
Head Strategies and Advisory
Real Estate Investment Management
Email: ulrich.braun@credit-suisse.com

Authors:
Zoltan Szelyes, CAIA, CFA
Head of Global Real Estate Strategy
Real Estate Investment Management
Email: zoltan.szelyes@credit-suisse.com

Dr. Andreas Wiencke
Business Management & Sustainability
Real Estate Investment Management
Email: andreas.wiencke@credit-suisse.com

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