October 2017

Real Estate Strategies

Key Takeaways from the Expo Real 2017

Welcome to the Latest Edition of Real Estate Strategies:

Summary

- This year's Expo Real has broken previous records with over 41 500 participants, an increase of 6,1% vs. last year's numbers.
- The **sentiment** towards real estate remains **upbeat**. We also believe that global and European real estate markets are further supported by the current favorable macroeconomic environment. We project positive rental growth in most global cities for the next three years.
- Returns for core assets are expected to moderate in the coming years due to the lower yield levels, but they are likely to remain competitive vs. other asset classes. Managers who can effectively implement active real estate strategies can add additional returns with **core+ and value-added investments**.
- Structural themes gained importance at the conference. We filtered out four key themes:
  - **Global logistics/urban warehouses** are likely to further gain from the trend towards e-tailing and we believe space demand is likely to be supported in the coming years.
  - **European healthcare real estate** is underpinned by demographic trends and the strong need to increase supply. We believe this asset class has strong potential to develop over the coming years, especially in Germany.
  - **International hospitality** is another big winner of the yield compression of traditional sectors. The positive trend is likely to continue even though we believe momentum will soften.
  - **Commercial real estate debt** as a real estate sub-segment is likely to gain more importance for European institutional investors due to trends in banking regulation and the current point in the interest rate cycle.
- Real estate is a digital late mover compared to other industries but the conference showed that digital trends are set to accelerate in the real estate industry. This "super trend" impacts the real estate in many ways, as themes such as data management and cybersecurity have shown at the conference.

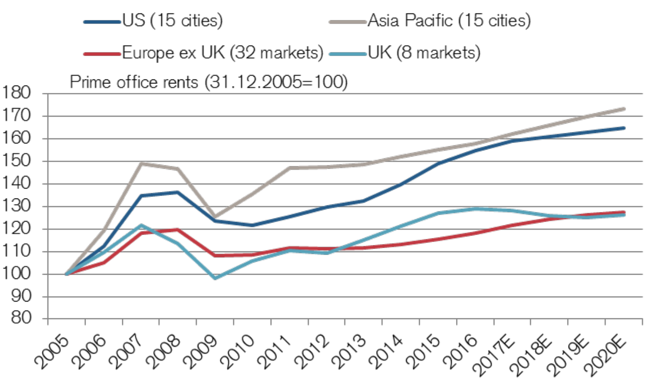
Expo Real 2017 Sets a New Record

This year's Expo Real, the 20th edition of Europe's largest "International Trade Fair for Property and Investment," took place between October 4 and October 6, 2017. More than 41 500 participants from over 75 countries gathered at the "Messeareal" in Munich. This amounts to an increase of 6,1% vs. last year's record participant numbers and highlights the current strong state of the industry and the secular trends toward real estate of most investors' investment portfolios.
This issue of the Real Estate Strategies summarizes the sentiment and the main topics discussed at the conference supplemented by our current research views.

Constructive Outlook for European and Global Real Estate

The level of optimism at the conference was similar to last year. The general environment for real estate continues to be supported by the ongoing low interest rates and inflation as well as the solid economic growth perspectives. While last year's conference was still clouded by some political risks in Europe, this year the outlook on the European economy has brightened up, as those risks haven't materialized. We believe some new political risks have arisen, such as North Korea, but political risks have abated in Europe and shifted to outside of Europe. Even for the UK, where the implementation of Brexit remains a challenge for rental markets, a strong bid for investments in central London has emerged and transaction volumes and prices have rebounded.

Figure 1: Rents likely to remain on an upward trajectory



Source: Credit Suisse, PMA; last data point: September 2017; Credit Suisse forecasts

Global Real Estate of Credit Suisse Asset Management believes that rental growth continues to support the real estate market globally. We project further positive rental growth - based on local demand and supply models - in all three global regions. With the exception of some short-term downside in rents in the UK, particularly in central London, we project positive rental growth of around 2% p.a. for the next three years globally.

As shown in figure 1, the rental increases have not been spectacular since the financial crisis but these gradual improvements are likely to continue and to support returns for real estate investors.

Core+ and Value-Added in Focus

The main current challenge to putting new money to work is the strong demand overhang for assets in the investment markets, which has driven down yields to historic lows in all regions. As the general low interest rate environment remains in place, we expect real estate net initial yield levels to remain stable over the next several years rather than to rise back to historic average levels. In line with the expected rental growth, this should pave the way for unleveraged returns for core assets in most markets of between 4% — 6%. Although this is lower than in the past three years, real estate still provides a yield pick-up of roughly 300 basis points vs. government bonds. Therefore, we believe that real estate as an asset class provides a powerful value proposition compared with available relative options in other asset classes.

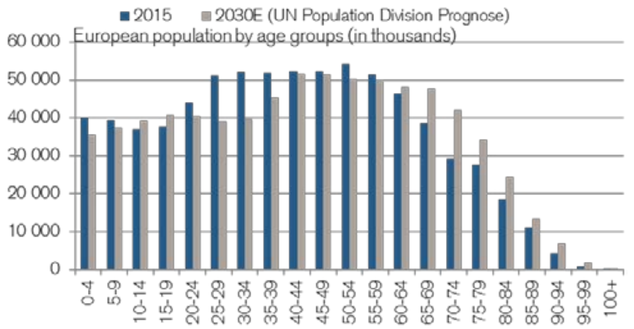
Investors looking for higher returns should seek exposure to value added strategies, where we think that additional returns can be achieved via active asset management strategies. Also, core fund managers can add value by investing in core+ strategies, as the strong demand for rentals allows landlords to rent empty spaces.

Structural Trends and Niches Gain Importance

Structural trends in societies also remained an important topic at the conference. The continuous rise of e-tailing as a prominent consumption channel paves the way for further growth in the logistics sector. In dense urban areas, where more and more consumers live and where remaining construction plots are scarce, innovation is required in order to increase storage capacities. The concept of urban warehouses, whose partly automated supply chain enables the integration of several floors of lower height into the building structure, constitutes a potential solution to meet future demand needs. We believe logistics will remain an important segment and recommend adding this type of asset to core and value-added portfolios.

The conference also saw many panels on healthcare real estate, an asset segment that has thus far been neglected by many investors. Satisfying the demand in the healthcare sector arising from aging groups in the Western countries will be challenging. In Germany alone, 300 000 additional senior housing beds will be needed by 2030. In the opinion of many experts, meeting this target will require the involvement of private players and this creates the business case for real estate investors, while yields provide a risk premium of over 500 basis points vs. government bonds. However, challenges related to this real estate niche, such as the required healthcare expertise as well as specific regulation hurdles, should not be overlooked.

Figure 2: Aging of the European population



Source: UN Population Database; last data point: 2015
September 2017; Credit Suisse forecasts

The tourism industry has prospered consistently over recent years and global travel numbers are expected to continue rising by > 4% annually over the next ten years, despite economic volatility, terrorism, and geo-political risks. Therefore, it comes as no surprise that hotel investments again took center stage at Expo Real for investors looking for yields in niche sectors. At the stand "World of Hospitality" 30 companies gave insights into their industry.

Generally, we believe that due to its attractive spreads to government bonds of often > 500 basis points, hotel investments will remain popular with real estate investors. However, we also believe that momentum built up over recent years will soften due to peaking markets and disruptive business models such as Airbnb.

Debt as Emerging Real Estate Segment for Investors

Commercial real estate debt was also featured in many panels at the conference. Unlike in the US, where commercial real estate debt is an established real estate sub-segment, it has yet to grow out its niche role in Europe and Asia. Banks are still the major players due to the importance of balance sheet lending. We believe that this might change in the future. The trends in European regulation of the banking sector (e.g. Capital Requirement Directive by the EU) as well as the impact of Solvency II for insurance companies point to an increased role for non-bank lenders in the provision of credit in the future. Several real estate debt funds have emerged in recent years offering different types of risk-return profiles to investors. In addition, some crowd-lending platforms have sprung up in Europe, including for mezzanine debt in Germany.

Due to the maturing real estate cycles and the resulting decline in real estate yields for core equity deals, real estate debt becomes more attractive and competitive for institutional investors in Europe and additionally allows them to diversify their risk. However, due to high margin competition in the German and French markets, investors need to apply a selective approach. We currently believe that senior secured debt is more attractive in Italy, Spain, UK, Benelux, as well as in the US.

Digitalization to Further Impact the Real Estate Industry

Real estate has so far been a laggard in adopting technological innovation. Nevertheless, the rise of technology and its related impact on the real estate industry were again at the heart of the debates at Expo Real 2017. Besides several panel discussions focusing on this theme, an area of the fair was dedicated solely to digital real estate start-ups (Real Estate Innovation Network) and Proptech founders were present in number. The growing exposure to digital innovation of one of the most prominent real estate fairs in the world constitutes a reassuring fact. The real estate industry is no longer at the stage of discovering the potential of digital technologies but is now seeking ways to implementing them into its processes on a large scale. Established real estate players should be keen on participating in this trend, as it is impacting their market environment in a dramatic way. Digital natives and digital converted (i.e. millennials) will soon overtake traditional consumers as main demand stakeholders, and tech companies have already started to reshape market rules in many real estate segments. Even on a smaller scale, digital innovation also impacts traditional workflows in the established industry. Artificial intelligence now enables the partial automation of due diligence processes for acquisition and sales activities, especially the very time-intensive document-screening part. Digitalization not only leads to gains in process efficiency, it also creates new duties. As real estate becomes a data-intensive sector, it becomes vulnerable to cyber-attacks as any other industry of the 21st century. Thus, integrating the cyber-crime factor into the security processes of the real estate industry has now become crucial in order to avoid disruptions.

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