Real Estate as an Asset Class
This document is aimed at private and institutional investors in Switzerland and exclusively at qualified investors outside of Switzerland.
- Cash flows, portfolio diversification, and protection against inflation: Real estate is a key asset class and can offer stable income returns, partial protection against inflation, and good diversification with other investments in the portfolio.

- International diversification: We recommend a globally diversified approach to supplementing local real estate portfolios.

- Different regional dynamics: A global portfolio should cover regions, real estate segments, and investment strategies and allow investors to participate in local developments, such as the momentum from various cities in emerging markets.

- Broad investment universe: Investors can implement an international real estate portfolio with directly investing real estate funds, REITs and real estate stocks, customized real estate mandates or club structures.
The ongoing near zero-interest rate environment in most industrialized nations poses a variety of challenges to private and institutional investors. On the one hand, traditional fixed-income investments do not provide the desired yield levels as they did in the past. On the other, when composing an investment portfolio, it must be remembered that it should also perform robustly in an environment that is characterized by less ample monetary liquidity— even if the current situation will remain for some time.

**Real Estate as a Strategic Asset Class**

Therefore, the advantages of real estate, such as a low correlation to other financial assets and relatively high, stable income returns, have come into greater focus. The real asset character of real estate offers investors stability in the current environment, which is subject to a number of uncertainties. Thus, investors are drawn to those real estate segments that are largely capable of producing income. In an international setting, this mainly includes investments in office and retail space. However, rental apartments, logistics properties, senior housing, or hotels are also in consideration.

We believe that as a strategic asset class, real estate belongs in the investment portfolios of institutional and private investors. Generally, real estate accounts for 5–30% of most investment portfolios. However, the strategic share of a real estate portfolio also depends on the investor’s individual situation and can be fine-tuned in respect thereof.

**International Diversification Recommended**

We also recommend an international focus, because international diversification can greatly improve the risk and return profile of a portfolio. While most investors still have a major «home bias» in their real estate portfolios, the trend toward a heavier international focus has been on the rise for some years.

As Figure 1 shows, the amount of international investments in commercial real estate was between 30% and 35%. As of the end of Q2 2014 (based on a 12-month period) real estate worth approximately EUR 190 billion was purchased by foreign investors. Current surveys show that this trend is likely to continue in the years to come. The best diversification is achieved with a global portfolio that includes properties in Asia, Europe, and the Americas. Even the inclusion of new investment countries improves the longer-term risk/return aspects of the portfolio when compared with a purely «domestic portfolio.»

**Sensitivity to interest rates and economic factors**

Due to the current low interest rate environment, there is a greater emphasis on the vulnerability of the investments to rising interest rates. Due to the importance of borrowing and the significance of risk-free interest rates in discount rates one would expect a certain amount of interest sensitivity of commercial real estate investments. However, as Figure 2 shows, prime office properties are currently trading at above-average risk premiums in most markets, based on a historical comparison. Therefore, these relative high spreads between real estate and bond yields act as a buffer against rising interest rates. The comparison with the situation in mid-2007, which was the peak of commercial real estate prices in the last cycle, also shows that commercial real estate remains appropriately valued.

**Executive Summary**
The development in rents is crucial for real estate returns. It also depends on economic trends, because the demand for rental space grows during phases of economic expansion and drops during recessions.

Figure 3 compares the total returns of global real estate portfolios with those of US government bonds with a maturity of ten years and global economic growth. Over the last 23 years, the correlation coefficient between government bonds and both of these real estate portfolios is nearly zero. The conclusion is that a globally diversified real estate portfolio was little related to the US interest rate cycle. However, there has been a high correlation (between 0.8 and 0.9) with global economic growth. This shows that real economic developments and the balance between local supply and demand play a key role in determining real estate values.

Fig 3: Total global returns on real estate had a low correlation to US government bonds

The global synthetic portfolio is based on a portfolio of total returns (Source: PMA) for prime office investments in 65 cities, which were weighted based on historical transaction volumes. All figures listed in local currency

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance. Last data point: December 2013

How to Invest in Real Estate

Investors seeking successful investments in real estate have to cover a wide range of specialist functions that are needed for implementing the real estate strategy and managing international real estate portfolios. Because most investors do not have these specific resources, we recommend investing via indirect real estate investment vehicles, customized real estate mandates, or property clubs.

The selection of investment vehicle also depends on the individual situation and the investor’s needs. As they are traded on stock exchanges, public investment vehicles offer investors liquidity. However, their correlation to the financial markets is higher.

Private investment solutions, for their part, are generally available only to institutional investors or qualified investors. Such investments offer the option to participate in the development of direct investments in the real estate markets. They possess a lower correlation to the financial markets, but generally also have lower liquidity compared with public investment alternatives.

There is also the option to diversify the investment using private and public vehicles. This may be a good idea especially when investors themselves want to actively vary their real estate holdings in a tactical allocation context on a monthly or quarterly basis. Even in this case it may be worthwhile to hold part of the investments in private structures while managing the tactical variation with REITs and real estate equities.

Sources: IPD, PMA, RCA, IMF, Credit Suisse.
1. The Case for Real Estate as an Investment

Real estate has a number of attractive characteristics for investors. This includes the diversification benefit due to low correlation with other asset categories, relatively high and stable cash flow returns, and the option to increase the potential returns by using debt.

Diversification through Real Estate

From a portfolio standpoint, the low correlation with other asset classes is definitely an important argument for investing in real estate. This means that by adding real estate to an existing portfolio of equities and bonds, investors can gain diversification benefits. In other words, the similar portfolio returns can be generated with a lower risk, or higher returns can be generated with the same risk. The correlation coefficient among the various asset classes in Tab. 1 show the extent to which the asset classes are similar or different in performance. The diversification potential also depends on the type of investment that is used to gain exposure to real estate. As expected, publicly listed REITs and real estate equities with a value of 0.8 have a relatively high correlation with the stock market, while the performance of direct real estate investments is much less dependent on that of other asset classes. Its correlation with the equity market is relatively low at 0.3, and even slightly negative in the case of the bond market, at -0.15. This makes real estate an attractive component in a broadly diversified investment portfolio.

Hedge against Inflation

Real estate is a real asset that offers investors partial protection against rising inflation, similar to some commodities or inflation-linked bonds.

Due to the stable nature of rental income, income yields are a relatively constant component of real estate returns. Because rental contracts are typically indexed to inflation, income should also keep pace with inflation. Rental agreements for office properties are generally linked to the consumer price index, while leases for retail space can sometimes be linked to the retailers’ merchandise sales. The link to inflation can be different depending on the country:

- **Continental Europe**: In many continental European countries, rents are indexed directly to the Consumer Price Index (CPI), as it is in Switzerland. Germany has a rent review once inflation crosses a certain threshold. Another option is partial indexing, as is the case in Italy, for instance. There, 75% of the inflation will impact the rent (not including fuel and tobacco price changes). If annual inflation is 3%, this results in a 2.25% rent increase.
- **United Kingdom**: Rents are adjusted to inflation or the market typically every five years, whereby rents can only be increased to positive inflation.
- **US**: Commercial real estate rents are generally increased annually at a fixed percentage of 2–3%.
- **Australia**: Leases for shopping malls usually include an annual increase – either a fixed rate of 4–5% or the rate of inflation plus another 1.0–1.5%. There are various options for rent prices in office and industrial space, including fixed increases, based on the rate of inflation or a current market analysis.

### Tab. 1: Correlation of price changes (all indices in local currency)*

<table>
<thead>
<tr>
<th>All indices are price indexes</th>
<th>MSCI World</th>
<th>10-year US government bonds</th>
<th>Global REITs / real estate equities</th>
<th>Direct investments in office real estate, global</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI World</td>
<td>1</td>
<td>-0.6</td>
<td>0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>10-year US government bonds</td>
<td>–</td>
<td>1</td>
<td>-0.34</td>
<td>-0.15</td>
</tr>
<tr>
<td>Global REITs / real estate equities</td>
<td>–</td>
<td>–</td>
<td>1</td>
<td>0.35</td>
</tr>
<tr>
<td>Direct investments in office real estate, global</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>1</td>
</tr>
</tbody>
</table>

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance. Last data point: June 2014

Source: IPD, Credit Suisse

### Relatively High, Stable Cash Flow Returns

In the current macroeconomic environment of continued low interest rate levels, the focus is often on generating relatively high, stable yields with real estate. Figure 4 shows the performance of global total returns and of both components – income returns and capital values growth since 2001. While returns from changes in capital values typically have cyclical fluctuations, the income yield was 5%–7% and is therefore a stable component of the total returns achieved.
Generally there is no direct adjustment to inflation in Japan and Singapore. The lease terms are short and the rents are adjusted to the market rate once the terms are up.

**Potential Returns due to Market Inefficiencies and Leverage**

There are two other characteristics to consider when looking at real estate from a return standpoint. The “total returns” are based on the total income returns and the changes in capital value (see Figure 4) which result from the performance of the property. This gives a real estate investment not only a fixed-income component but also additional return potential, which can have a positive (or negative) influence on the total returns.

By anticipating various market developments, there is the possibility to add value. Various research papers, including by Nobel Prize winner Robert Shiller, show that real estate markets are not always informational efficient.

The term “market efficiency” refers to the potential for generating alpha or forecasting market developments. If prices contained all available information, investors could not generate additional returns compared to the market and also market developments would be hard to forecast. Even if real estate cycles do not always proceed as expected, various market inefficiencies are present that investors can take advantage of.

This is due on the one hand to the fact that, unlike other asset classes, no short sales can be made in real estate that could make up for price distortions. On the other hand, this is also due to the length of the cycles and due to the fact that real estate is a heterogeneous asset class.

Another way of increasing returns is to use borrowed funds. Here’s a simple calculation to explain the leverage effect: If a rental property worth CHF 20 million and with annual income of CHF 1,000,000 is 100% equity-financed, the return on equity is 5%. If half of the asset value is financed by debt at an interest rate of 2%, the income is reduced to CHF 800,000, but the return on equity then increases to 8%. When using borrowed funds, it must be remembered that it can greatly increase an investment’s risks. The financial market crisis is a good example of how high leverage can lead to pro-cyclical behavior.

---

2. Reasons for an International Approach

Although investors and portfolio managers have long realized the opportunities of real estate investments, many restrict themselves to their home markets. In many portfolios, exposure to foreign real estate is just a small part of the total investment volume (see box, “Pension Funds: Home Base Focus”). This is mainly because markets vary greatly from country to country and investors often know their own market best. However, by investing in international markets, investors can not only benefit from developments outside their own countries, but also diversify their portfolio and improve the risk-return profile.

"Home Bias" of pension funds

The chart shows the results from a survey of 59 pension funds regarding the country allocations in their real estate portfolios. In the UK, Germany, Scandinavia, and Switzerland, less than half of the pension funds surveyed invest in real estate outside their home countries; less than one-third have an exposure of outside Europe.

Fig. 5: Survey of 59 pension funds in %

Sources: European Institutional Real Estate Survey (EIRES) 2013, Credit Suisse

Market Size and Participation in Positive Developments Outside the Home Market

A global approach greatly enhances investment opportunities. According to estimates, the global market for commercial real estate in 2011 was approximately USD 26.6 trillion, and by 2021 it will grow by 83% to USD 48.7 trillion. In 2011, the Swiss real estate market accounted for only 1% of the global real estate market, at USD 284 billion. Germany and the UK were somewhat higher, with a share of more than 6% or 5% of global volume (figures from Pramerica Real Estate Investors, “A Bird’s Eye View of Global Real Estate Markets: 2012 Update”). Thus, the investment universe is growing exponentially for investors (see box: “Development of the Global Market for Commercial Real Estate” with regard to the forecast growth in the global commercial real estate market).

However, a global approach does not just mean greater investment opportunities in terms of volume. At the same time, investors can partake in positive economic developments and trends from other countries, such as the upcoming middle class in many emerging markets.

Development of the Global Market for Commercial Real Estate

The two charts below show the forecasted growth in commercial real estate markets in the various regions, along with their share in total volume. Accordingly, the Asia-Pacific region will surpass Europe as the largest market by 2021. Based on estimates, it will account for about 39% of the total market with an estimated volume of USD 19.1 trillion.

Fig. 6: Commercial real estate markets by region in trillions of USD

Fig. 7: Regional share of the global commercial real estate market

Source: Pramerica Real Estate Investors (“A Bird’s Eye View of Global Real Estate Markets: 2012 Update), Credit Suisse
Real estate markets in different countries can also be at a different phase in the real estate cycle. Thus, depending on the risk/return profile of an investor, other markets may be more suitable or interesting.

Figure 8 illustrates the development in capital values for prime office space in various regions and markets since the end of 2000. The general correction during the financial crisis in 2008/2009 and the subsequent recovery is certainly a striking feature of recent years. However, the figure also shows the differences among the regions. For instance, following the financial crisis, the prices rose stronger in the liquid markets, such as London and New York, than they did in the other markets of Europe and the US.

On the one hand, this shows investors’ preference for core properties in top locations. On the other, this sharp increase indicates that the potential has already been more extensively tapped. However, a recovery in other real estate markets, such as regional cities in the UK, Germany, and Japan, in the Netherlands or the Iberian Peninsula, is less advanced and provides opportunities to investors.

In addition to a geographic distinction of markets, we can also classify them based on the business sector, which is a key driver of demand for commercial space. For instance, markets can be distinguished by whether they are mainly driven by commodities, finance, or government sector. The first category includes cities such as Brisbane, Perth, Calgary, and Santiago de Chile. Markets that largely depend on the financial industry are typically London, New York, and Tokyo, while the commercial real estate demand in cities like Berlin and Washington D.C. depends stronger on the public sector. The formation of such industry clusters allows us to identify key drivers of each real estate market, to avoid any problematic segments, and to diversify across various industries. Generally, a global approach means we can identify such differences and use them accordingly in a suitable portfolio strategy.
**Broad Range of Yields**
A global approach not only allows for participation in the market developments of various countries, but also increases the range of potential yields. Figure 9 shows the current net prime office yields in selected cities, in the context of historically realized lows or highs. This makes it clear on the one hand that returns have reverted to a lower level in some Asian, and even European, cities such as Zurich, London, Paris, and large German cities. However, returns in southern European cities remain in the upper range of historically realized figures. This underscores once again that office real estate markets in Europe are recovering differently in terms of intensity and cycle.

A cross-section also shows that thanks to a global approach, the range of realizable yield increases greatly. Based on the cities studied here, the difference between the lowest return in Hong Kong and the highest in Athens was about 550 bps in Q3 2014.

**International Diversification**
Investors also can benefit from the diversification potential of a global investment approach. In general, the risks that affect a real estate portfolio can be divided into non-systematic and systematic risks (Fig. 10). Non-systematic, i.e. diversifiable risks, include property risks, along with local and national/regional market risks. By investing in various properties, in different local markets, the risks can be diversified at the property and the local level. However, if a portfolio is invested only in the home market, all properties will always be subject to the same national trends, such as employment base and growth, demographic changes, inflation, and regulation. This non-systematic risk can be reduced with a global portfolio strategy. The potential for diversification depends on the return correlation among the various markets. Tab. 2 shows the correlation coefficients among the total returns of various countries. Of particular note are the low correlation values of Hong Kong, which are even in the negative range for some European countries (Germany, Italy, Netherlands, Spain). Also interesting in terms of potential diversification are Germany and Singapore, which have low to medium coefficients. Traditionally, there is a high correlation between the US and UK (here with a value of 0.71); especially prices in New York and London are often moving in similar ways.

![Fig. 10: Systematic and unsystematic risk](image)

**Tab. 2: Estimated correlation matrix for annual total returns on office space for selected countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>France</th>
<th>Germany</th>
<th>Ireland</th>
<th>Italy</th>
<th>Netherlands</th>
<th>Spain</th>
<th>UK</th>
<th>USA</th>
<th>Japan</th>
<th>Australia</th>
<th>Hong Kong</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>1.00</td>
<td>0.56</td>
<td>0.65</td>
<td>0.61</td>
<td>0.52</td>
<td>0.74</td>
<td>0.66</td>
<td>0.75</td>
<td>0.56</td>
<td>0.27</td>
<td>0.39</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.00</td>
<td>0.48</td>
<td>0.44</td>
<td>0.49</td>
<td>0.63</td>
<td>0.63</td>
<td>0.14</td>
<td>0.28</td>
<td>0.48</td>
<td>0.05</td>
<td>-0.08</td>
<td>0.39</td>
</tr>
<tr>
<td>Ireland</td>
<td>1.00</td>
<td>0.39</td>
<td>0.67</td>
<td>0.78</td>
<td>0.52</td>
<td>0.61</td>
<td>0.61</td>
<td>0.61</td>
<td>0.46</td>
<td>0.06</td>
<td>0.29</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>1.00</td>
<td>0.57</td>
<td>0.71</td>
<td>0.33</td>
<td>0.40</td>
<td>0.38</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
<td>-0.13</td>
<td>0.12</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.00</td>
<td>0.77</td>
<td>0.36</td>
<td>0.57</td>
<td>0.32</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.18</td>
<td>-0.40</td>
<td>0.40</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>1.00</td>
<td>0.42</td>
<td>0.59</td>
<td>0.59</td>
<td>0.49</td>
<td>0.49</td>
<td>0.49</td>
<td>0.49</td>
<td>0.13</td>
<td>-0.13</td>
<td>0.24</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>1.00</td>
<td>0.71</td>
<td>0.50</td>
<td>0.65</td>
<td>0.41</td>
<td>0.41</td>
<td>0.41</td>
<td>0.41</td>
<td>0.37</td>
<td>0.37</td>
<td>0.37</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>1.00</td>
<td>0.65</td>
<td>0.76</td>
<td>0.28</td>
<td>0.58</td>
<td>0.58</td>
<td>0.58</td>
<td>0.58</td>
<td>0.58</td>
<td>0.58</td>
<td>0.58</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>1.00</td>
<td>0.52</td>
<td>0.24</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td>0.43</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>1.00</td>
<td>0.19</td>
<td>0.54</td>
<td>1.00</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1.00</td>
<td>0.45</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td></td>
</tr>
</tbody>
</table>

*Total returns on a national level correspond to the weighted total returns of each leading city; Historical performance indications and financial market scenarios are not reliable indicators of current or future performance. Last data point: March 2014
Source: PMA, Credit Suisse
3. Setting up a Global Portfolio

Based on general portfolio theory, an asset can be sufficiently described by its expected return, risk, and correlation to other assets in order to calculate a globally diversified portfolio. However, these purely quantitative methods typically have their practical limits and often result in corner solutions. Figure 11 shows the global allocation recommended by the model, arranged by the historically realized returns on a portfolio of this kind.

Various markets with little international relevance would be heavily weighted under such model calculations, due to the returns achieved there in past years (e.g., Beijing and Perth) or their low standard deviation (Marseilles, Cologne, and Lyon). However, this calculation also makes it clear that the European markets have a lower risk/return profile than American or various Asian markets, and would be weighted more heavily in more defensive portfolios.

Fig. 11: Market allocation based on a purely mathematical approach

We have drawn up a portfolio based on the return data for 37 European, 11 US, and 15 Asian office real estate locations between 2001 and 2013. Maximum weight of 20% per market is the only model restriction assumed.

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance. Last data point: December 2013
Source: PMA, Credit Suisse

Combination of Quantitative Approaches and Qualitative Factors

We feel that the structure of a global portfolio must be based on a quantitative and qualitative approach. To ensure a balanced portfolio, the economic significance of the various regions or historical transaction volumes can also be accounted for as additional factors to define the optimal strategic regional weighting.

Table 3 shows the summary of these different influential factors. While the model allocation recommends heavy weighting in Asia depending on the risk/return segment, the historical economic development and liquidity of the commercial real estate markets give a heavier weight to Europe and the US.

In the synthesis it must also be considered that for the Americas, allocation in Canada and Latin America is also desirable. Asia is likely to experience the greatest economic momentum in the next decades. Therefore, for a global portfolio there are good arguments for a relatively equal regional distribution that can fluctuate between 25% and 45% for the individual region.

Tab. 3: Possible regional allocations

“Economic significance” measures the relative economic development and size of the real estate capital market relative to the real estate volumes in commercial real estate since 2001. The result of the quantitative model is the bandwidth of the relative market allocation based on the mathematical process shown in Figure 11.

Diversification Recommended Even within the Regions

For each region, we recommend diversifying the portfolio by market, real estate segments, and the tenant industries. In the current environment, this means that for European allocation, for instance, markets that ensure cash flow stability in the portfolio, such as office or retail space in Germany, can be combined with markets like Spain, Ireland, the Netherlands, or UK regional markets that possess potential for value appreciation. In America, investments can be diversified with US coastal cities, commodity hubs in the southern US, and various Canadian markets. If possible, investments in Latin America should be considered as well. In Asia, we prefer the combination of Australia/New Zealand and markets in northern and southeast Asia, such as Japan, Singapore, and Hong Kong.

Increasing Transparency in the Emerging Markets

A key factor that prevented the formation of global portfolios in the past was the different transparency levels in the real estate markets. Table 4 shows the first 20 countries of the 2014 JLL Transparency Index, which rates 102 countries based on their transparency in the real estate sector. The criteria include performance evaluation for direct and indirect real estate
investments, the availability of fundamental market data, and the financial disclosure and corporate governance of listed investment vehicles. Moreover, legal and regulatory framework conditions, along with the flow of transaction processes, are also analyzed. First place is traditionally held by English-speaking countries, whereby the UK, the US, Australia, and New Zealand take the first four spots in the latest study. In more than 80 percent of the markets, the transparency improved in comparison with the last ranking in 2012. In general, we can see a trend toward a more open data policy in the public and private sectors. For example, the continued recovery in the international real estate markets is leading to greater risk tolerance on the part of investors: While they are willing to implement projects in new markets, they expect ever greater levels of transparency. At the same time, governments have realized that the lack of transparency has a negative impact on investment activity and therefore they are dedicated to measures and initiatives that increase transparency. Nonetheless, some countries still have great potential for better transparency, which makes investment decisions and project implementation more difficult, especially for foreign investors, or requires high costs.

Tab. 4: The 20 most transparent real estate markets according to the 2014 JLL Transparency Index

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Rank</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United Kingdom</td>
<td>11</td>
<td>Sweden</td>
</tr>
<tr>
<td>2</td>
<td>USA</td>
<td>12</td>
<td>Germany</td>
</tr>
<tr>
<td>3</td>
<td>Australia</td>
<td>13</td>
<td>Singapore</td>
</tr>
<tr>
<td>4</td>
<td>New Zealand</td>
<td>14</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>5</td>
<td>France</td>
<td>15</td>
<td>Belgium</td>
</tr>
<tr>
<td>6</td>
<td>Canada</td>
<td>16</td>
<td>Denmark</td>
</tr>
<tr>
<td>7</td>
<td>Netherlands</td>
<td>17</td>
<td>Poland</td>
</tr>
<tr>
<td>8</td>
<td>Ireland</td>
<td>18</td>
<td>Spain</td>
</tr>
<tr>
<td>9</td>
<td>Finland</td>
<td>19</td>
<td>Norway</td>
</tr>
<tr>
<td>10</td>
<td>Switzerland</td>
<td>20</td>
<td>South Africa</td>
</tr>
</tbody>
</table>

Source: JLL Global Real Estate Transparency Index 2014, Credit Suisse
4. Implementation within Credit Suisse

Apoquindo 5400 in Santiago de Chile, an investment of one of the Credit Suisse real estate funds

Source: Credit Suisse

The real estate strategy outlined in the prior section is a starting point. However, ultimately it is just an element in the entire value chain that is needed to establish and manage an internationally diversified real estate portfolio. Therefore, below we will describe here for illustrative purposes how real estate, as an investment in an international context, is implemented at Credit Suisse.

The track record of Credit Suisse Real Estate Asset Management began with the launch of the first Swiss real estate fund in 1938. Today, Credit Suisse is among the world’s largest real estate investment managers; measured in terms of assets under management, it is the third largest real estate asset manager in Europe and number one in Switzerland.

Structured Portfolio Management Process

This development is based on a very simple, clearly structured portfolio management process. As stated above, first a real estate strategy is defined. To this end, a top-down-macro oriented research analysis and bottom-up-oriented market information from local real estate managers or acquisition specialist is combined. To minimize conflicts of interest, we endeavor to ensure that the strategies of each investment product have a minimum amount of overlap. For international projects, currency hedging is also a key factor.

Based on the defined strategy, the core of the value chain is activated. This consists of the three sub-elements “Buy – Optimize/Manage – Sell.”

“Buy”

The acquisition goal is to purchase properties that meet the strategy requirements of the different products. The properties or construction projects are referred to the acquisition department by direct contact with companies, real estate brokers, general contractors/full-service providers, or Credit Suisse RMs. After a thorough review, the properties are submitted to the Investment Committee and then placed in the right investment vehicle by the Assignment Committee, whereby the conditions for price negotiation are also defined. After submission of a preliminary purchase price as part of a non-binding offer (NBO), a thorough due diligence review is conducted, under which the property is inspected and evaluated by various (internal and external) parties. If the due diligence review is satisfactory, after consent by the relevant executive bodies, a binding purchase offer is submitted for a real estate portfolio.

On average, of 100 properties that are reviewed in the acquisition process, five to ten are purchased. It typically takes between two and six months to purchase a property. In 2013, Real Estate Asset Management at Credit Suisse purchased real estate in excess of CHF 1,225 million.

![Fig. 12: Value chain for real estate at Credit Suisse](Image)
"Optimize/Manage"

The product manager is responsible for managing the relevant real estate product. This includes many activities, including portfolio management. However, operational management and the coordination of various processes on a day-to-day basis are also part of the specified tasks. He or she also works closely with Property Asset Management (PAM), which offers support during the holding period of the properties. For each property, a strategy or property-specific business plan is created. Here, income and value-added potential are assessed and plans implemented where sensible.

Further, PAM is responsible for the rent policy and its implementation, and is in charge of the operational real estate providers such as managers or marketers. Last but not least, this department also concludes master agreements, which can use economies of scale to the fullest extent. Examples include active master agreements for elevators, gas deliveries, and white goods – there are also pilot projects under way for lighting, electricity, and solar facilities.

A key element in the optimization phase are renovations or reconstructions. Each year, the construction team of Real Estate Asset Management initiates some CHF 190 million of investment volume in this area. Along with the supervision of new construction projects, the total sales in 2013 were CHF 990 million.

Among the largest new construction projects in recent years was Sihlcity in Zurich, where Credit Suisse Real Estate Asset Management is headquartered. Internationally, key projects include the realization of the expansion to the Vancouver Exchange and the Apoquindo in Santiago de Chile.

“Sell”

If the real estate strategy has low potential – for instance, if the costs of renovation cannot be compensated for by rent increases – or a property no longer fits with the investment’s adopted strategy, it is offered for sale. In 2013, real estate worth more than CHF 725 million was sold.

Strategy Review and Reporting

In regular intervals and based on clearly defined processes, the strategy of each real estate portfolio is checked and the results are shown in client reports. The transparency of investment plans has greatly improved over the years and can generally be reflected for each property using key figures such as cost price, current market value, rental income, or vacancy.

Integrated, Comprehensive Approach for Real Estate

Along the entire value chain, Real Estate Asset Management has access to more than 210 dedicated, internal real estate experts. Management functions and core processes are performed internally – most supporting functions are outsourced to renowned real estate service companies. All of the various interfaces, processes, and staff involved in the various global regions together comprise highly complex investment processes. However, we feel that a professional, globally networked platform is needed to successfully implement a global real estate strategy.
5. How to Invest?

Investors seeking exposure to real estate have a number of options (see table 5). Typically, a real estate investment means an investment in the equity segment, but could also be an investment in debt structures. The second dimension is the distinction between publicly accessible vehicles and private investment opportunities. This distinction can be based on various factors, such as a public stock listing or legal criteria – for example, private placements for bonds.

Table 5: Categories of real estate investments

<table>
<thead>
<tr>
<th>Equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private</td>
<td>Direct investments with mandates or property clubs</td>
</tr>
<tr>
<td></td>
<td>Non-listed real estate funds and funds of funds</td>
</tr>
<tr>
<td></td>
<td>Real estate foundations</td>
</tr>
<tr>
<td>Public</td>
<td>Real estate equities</td>
</tr>
<tr>
<td></td>
<td>Listed real estate investment trusts (equity REITs)</td>
</tr>
<tr>
<td></td>
<td>Listed real estate funds</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Credit Suisse

Private investments (equity segment)
The private equity market includes direct investments in real estate along with investments in non-listed real estate funds and fund of funds. For direct investments, the investors are directly involved in the decisions regarding the strategy or composition of their portfolio and benefit from the aforementioned advantages of this asset class. Professional management of the real estate portfolio, which includes a wide range of skills and competencies, is needed to successfully implement the real estate strategy in practice. If investors cannot cover all of these required functions alone, it is advisable for them to implement direct investments using mandate or property club structures. With both solutions, they can rely on the skills and experience of professional institutional real estate investors, but remain in the driving seat of the investment process. For non-discretionary mandates of this kind, they can decide which properties they want to buy, as they are generally present for the property inspections. Because mandates of this kind have relatively high minimum requirements, there is also the option to invest in real estate using club structures. Various investors form an investment club for this type of structure. The investors are intensively involved in the acquisition process. They can decide on the purchase of properties, but the management and sale of the properties is delegated to the asset manager in order to avoid conflicts of interest.

Further, private real estate funds or funds of funds are part of private real estate investments. This includes open and closed ended structures and products that have a fixed or an unlimited life. Various products tend to vary greatly from one another in terms of risk assumption, as we will discuss below. Such private vehicles are only available to institutional investors or qualified private investors².

Publicly Listed Real Estate Investment Vehicles
Public real estate includes investments in real estate equities, Real Estate Investment Trusts (REITs), and publicly accessible real estate funds that directly hold real estate. These investments are typically available to all investors and offer access to diversified real estate portfolios with relatively small denominations. Moreover, investors benefit from the higher liquidity of listed instruments. REITs are a special case for real estate equities. They generally have higher direct dividend yields than “normal” real estate equities and offer tax advantages in certain countries. However, they are also subject to various restrictions. In terms of managing the real estate portfolio, non-REIT real estate companies have a higher level of flexibility. As they are also typically involved in construction projects, they have a higher risk profile than REITs.

However, the disadvantages of these public vehicles are a higher volatility, a higher correlation with equities, and greater interest sensitivity compared with direct investments. These disadvantages are offset by their higher liquidity, as the shares are publicly traded on stock exchanges. Generally, the price of such a vehicle differs by the NAV, and the shares are traded for a premium or discount on NAV. Therefore, investing in real estate using such vehicles requires a further analytical dimension: valuation at vehicle level. In the short term, therefore, the performance of such vehicles can differ greatly from those in direct investments. The field of publicly accessible real estate funds also depends greatly on local conditions. For instance, Switzerland has domestic and globally invested real estate funds that are traded on the stock exchange. These are liquid and typically include premiums or discounts in the NAV. Their correlation to the equity market and volatility is substantially lower than that of REITs and real estate equities. However, German public real estate funds are open-end structures and offer investors liquidity at the NAV. Here too, the individual situation must be analyzed to see which structure best fits the investor’s portfolio.

¹Qualified investor status can vary from country to country. The term generally denotes institutional investors, HNWIs, and investors with comprehensive experience in financial investments.
Private vs. Public Debt Markets

Particularly in English speaking countries, real estate debt has become an established investment segment. This means that investors are essential lenders or assume the credit risk from creditors. Generally, real estate loans have a lower risk/return profile than investments in real estate equity. However, the risk can vary depending on the investment and seniority of the loan. One area of overlap between the private and the public is that of mortgage-backed securities or covered bonds. These covered bonds are bonds that have additional security from mortgages. They are typically issued by banks or other financial institutions and generally have lower interest than non-secured bonds. However, mortgage-backed securities consolidate a portfolio of real estate loans and slice and dice them into a bond. Such bonds generally follow “pass through” structures, i.e. the interest income and repayment of principal of the underlying loans are passed on directly to investors using a “cash waterfall” system. Depending on the country or structure, such bonds can be public or private.

Different Investment Styles

The choice of the investment style is also a key decision for real estate investments. It has a major impact on the characteristics of the real estate portfolio. Depending on their risk/return profile, real estate and indirect investment vehicles can be divided into core, core+, value-added, and opportunistic (see Figure 13).

Core objects are properties at good locations and have a high level of quality alongside existing, long-term leases. Returns are mainly generated by the rental income component, although total returns can vary over time. The core+ strategy deviates somewhat from the high requirements of core in a number of areas. For instance, a property may be located less centrally, the leases can have shorter terms, or the investment can be made with a higher amount of borrowing. This means a higher risk/return profile than with the core approach.

For returns on a value-added approach, income and value enhancement play a role, whereby the value enhancement component takes on greater meaning here. Various approaches can be used. Often, the value is enhanced using renovations, new leases, or non-speculative project developments. One alternative is to ride the market cycle. With market timing, higher risks in markets with a higher value-added potential are taken. The debt portion is also typically much higher for value-added than for core and loan to value ratios range typically between 40% and 60%. Opportunistic strategies have an even higher risk profile than value-added and often contain a highly speculative element and loan to value ratios above 70%.

Figure 13: Investment styles

Opportunity to use the “Core Satellite” Investment Approach

Because most real estate investors’ focus is on stable income returns, it is recommended to implement most of the real estate allocation using core and core+ strategies. In this context, many investors use the “core satellite” investment approach. Most of the investments are made in core strategies, but a small portion of the investment aims to generate higher returns using value-added or opportunistic strategies. The potential success of value-added strategies depends on the market cycle. The ideal conditions are offered by markets in which higher rates of vacancy prevail, but there are expectations to drop over the investment horizon, while real estate values may rise due to higher rents. In particular, various European markets such as Spain, Ireland, or British regional cities, and some US markets are currently attractive for using value-added strategies. Thus, they can be appealing to those investors who wish to enrich their real estate portfolio with higher potential returns.
Impressum

Copyright
The publication may be quoted providing the source is indicated. Copyright © 2014 Credit Suisse Group AG and/or affiliated companies. All rights reserved.

Cover image
Sydney 52 Golbourn Street
Source: Credit Suisse

Edition
1. edition: October 2014

Publisher
Strategies and Advisory
Credit Suisse Real Estate Asset Management

Disclaimer
This document was produced by Credit Suisse AG and/or its affiliates (hereafter “CS”) with the greatest of care and to the best of its knowledge and belief. However, CS provides no guarantee with regard to its content and completeness and does not accept any liability for losses which might arise from making use of this information. The opinions expressed in this document are those of CS at the time of writing and are subject to change at any time without notice. If nothing is indicated to the contrary, all figures are unaudited. This document is provided for information purposes only and is for the exclusive use of the recipient. It does not constitute an offer or a recommendation to buy or sell financial instruments or banking services and does not release the recipient from exercising his/her own judgment. The recipient is in particular recommended to check that the information provided is in line with his/her own circumstances with regard to any legal, regulatory, tax or other consequences, if necessary with the help of a professional advisor. This document may not be reproduced either in part or in full without the written permission of CS. It is expressly not intended for persons who, due to their nationality or place of residence, are not permitted access to such information under local law. Neither this document nor any copy thereof may be sent, taken into or distributed in the United States or to any U. S. person (within the meaning of Regulation S under the US Securities Act of 1933, as amended). Every investment involves risk, especially with regard to fluctuations in value and return. Investments in foreign currencies involve the additional risk that the foreign currency might lose value against the investors reference currency. It should be noted that historical returns and financial market scenarios are not reliable indicators of future performance.

The key risks of real estate funds include limited liquidity in the real estate market, changing mortgage interest rates, subjective valuation of real estate, inherent risks with respect to the construction of buildings and environmental risks (e.g. land contamination).

When distributed or accessed from Austria, this document is distributed by CREDIT SUISSE (LUXEMBOURG) S.A. Zweigniederlassung Österreich, a branch of CREDIT SUISSE (LUXEMBOURG) S.A., a Luxembourg bank, authorized and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Its Austrian branch is further subject to the supervision the Austrian Financial Market Authority (FMA).

When distributed in the UAE, this information is distributed by Credit Suisse AG Dubai Branch, duly licensed and regulated by the Dubai Financial Services Authority (DFSA). Related financial products or services are only available to customers who qualify as either a Professional Client or a Market Counterparty under the DFSA rules and who have sufficient financial experience and understanding to participate in financial markets and satisfy the regulatory criteria to be a client.

When distributed from France, this report is distributed by Credit Suisse (France), authorized by the Autorité de Contrôle Prudentiel et de Résolution and the Autorité des Marchés Financiers. When distributed from Germany, this is distributed by Credit Suisse (Deutschland) AG, which is authorized and regulated by the Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin), disseminates research to its clients that has been prepared by one of its affiliates. When distributed from Qatar, this is distributed by Credit Suisse (Qatar) L.L.C, which has been authorized and is regulated by the Qatar Financial Centre Regulatory Authority (QFCRA) under QFC No. 00005. All related financial products or services will only be available to Business Customers or Market Counterparties (as defined by the Qatar Financial Centre Regulatory Authority (QFCRA) rules and regulations), including individuals, who have opted to be classified as a Business Customer, with liquid assets in excess of USD 1 million and who have sufficient financial knowledge, experience and understanding to participate in such products and/or services.

Copyright © 2014 Credit Suisse Group AG and/or its affiliates. All rights reserved.

www.credit-suisse.com/ch/realestate