Value-added investments are active real estate strategies. They have a higher risk and return profile than core investments and usually follow a J-curve.

We believe the disciplined application of a value approach is the key attribute of successful value-added real estate investment managers. Experienced asset and portfolio management, acquisition, finance, construction management and as well as research are essential skillsets for value added investments.

Given the advanced stage of the economic and real estate cycle we recommend a global approach. Better risk-adjusted returns can be achieved by combining different strategies in different regions than by investing in individual niches.

We recommend building a value-added investment portfolio around the following four market strategies.

- **Continuing shortages of supply** in selected office markets in the US (e.g. Boston, Seattle), Europe (e.g. Berlin, Munich, Paris, UK regional centres) and Asia-Pacific (e.g. Tokyo, Seoul and Melbourne) are a promising basis for the active repositioning of properties by means of capital expenditures, lease optimizations and vacancy management.

- **Possible countercyclical strategies** in the current environment include commodity-related cities, residential property in global gateways and UK retail. However, it should be noted that the investment period for value-added products is typically 2 to 3 years. We therefore expect a number of new countercyclical investment opportunities to present themselves in 2019 and 2020, which will require thorough analysis and decisive action to exploit them fully. This is the case in the US in particular, where we expect a rise in real estate capitalization rates.

- **Improving micro-locations** can be a further source of value-added returns. Submarkets which are seeing rising values owing to infrastructure projects (e.g. Grand Paris project, Crossrail in London, Tokyo station, Penn station in NY) or socio-demographic trends (e.g. Seoul Gangnam, Tokyo Shibuya, Seattle Bellevue, Chicago Fulton) offer potential for rising rents in office or mixed-use properties.

- **Structural changes** such as the growth in online shopping, the preference of younger generations for sharing versus ownership and for co-working and co-living will continue to lead to tectonic shifts in demand for real estate. Further opportunities include development of logistics properties (build to suit), acquisition and upgrading of urban logistics space (light industrial) or repurposing of industrial and retail sites into residential properties with additional services or a community character.
What are value-added investments?

Real estate strategies can be broken down into three categories: core, value-added (VA) and opportunistic (see Figure 1). Core strategies are relatively low risk, with returns mainly being generated by long-term leases. Opportunistic strategies are high-risk investments. They are often associated with an LTV of over 75% and may contain greenfield developments or investments in emerging markets with elevated political risks.

VA investors take the middle way. As in the opportunistic strategy, they aim to generate higher returns through stronger capital growth. However, active management, such as letting of vacant space, the optimization of leases and repositioning buildings through refurbishments or renovations are typical characteristics of VA strategies. These investments also typically follow what is known as a "J-curve". Investors only earn a profit when the business plan has been realized and the buildings are sold. Due to the need for an exit the success of value-added strategies is clearly measurable and the track record is verifiable based on market results.

Implementing the value approach in real estate

We believe that VA real estate strategies have the best chance of success when they follow a "value" investment philosophy. Most investors are familiar with the value approach in equities and bonds. This investment philosophy was first enunciated in Benjamin Graham and David Dodd’s legendary 1934 book "Security Analysis". The basic principle is to identify undervalued assets by means of research into the fundamental data of companies or markets.

The value approach in real estate differs from the approach in financial investments in a number of ways. Firstly, the macro or micro locations that offer potential for capital appreciation are to be identified. Secondly, each property is analyzed individually. The ability to accurately project the future costs and rental potential of the property is key to spotting a true value investment and so the potential increase in value that can be generated. Finally the plans must be implemented successfully. Effective asset and cash management, financing and building expertise are essential in determining whether the proposed strategies can be implemented successfully.

The benefit of a global focus

The question for investors is whether they prefer to implement their allocation to value-added real estate strategies via niche investments or a broadly-based portfolio comprising various market strategies and regions. A niche strategy is typically limited to a tightly defined region, often in combination with a specialized investment segment, such as student accommodation in the UK or regional malls on the west coast of the US.

The disadvantage of such niche strategies is that they are heavily dependent on local factors. Limiting oneself to a regional niche may work well for a time. However, it is unlikely to be successful throughout the entire cycle, as the market environment typically changes. We therefore recommend combining investments in different locations and a different market strategies in value-added portfolios. In view of the advanced stage of the real estate cycle and the fall in yields, we recommend a global approach to identifying value-added investment opportunities. This does not mean, though, that this kind of portfolio should be invested widely across many different countries irrespective of the economic cycle. On the contrary, this approach is based on identifying potential value in a selective and disciplined way at a global level and investing on a focused basis.

Combining different market strategies

Typically most VA investments involve letting vacant space, proactively optimizing lease agreements or capital investments. However, they differ with regard to the underlying market strategies, which we have broken down into six different categories.

<table>
<thead>
<tr>
<th>Investment type and location</th>
<th>Core</th>
<th>Value-added</th>
<th>Opportunistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate type and location</td>
<td>Stabilized portfolio properties</td>
<td>Properties with rental potential realized through active management</td>
<td>Problem properties with repositioning potential</td>
</tr>
<tr>
<td></td>
<td>High occupancy and stable income yields</td>
<td>Renovation and refurbishment</td>
<td>Greenfield development</td>
</tr>
<tr>
<td></td>
<td>Long-term leases</td>
<td>Less central properties</td>
<td>In non-established or emerging markets</td>
</tr>
<tr>
<td>Holding period</td>
<td>Unlimited</td>
<td>Typically 4–12 years</td>
<td>Typically 3–10 years</td>
</tr>
</tbody>
</table>

The disclaimer at the end of the document also applies to this page.

Source: Credit Suisse Asset Management Global Real Estate
A countercyclical strategy is typically employed after a correction of market prices and rents. In this environment assets are undervalued and the investor anticipates a recovery. As a result, modest levels of capex, lease and vacancy management produce results in this kind of environment.

It is a different picture in the second case of a shortage of supply. Here prices have typically already risen sharply, as the cycle is usually in full swing. Vacancies and the low level of construction point to a continuing shortage of supply. As a result capital-intensive building measures or a complete repurposing of the property are often required. A lack of new supply and high rental demand mean that rent increases can be implemented after the space has been refurbished. There is also high investment demand from core real estate investors in such an environment, which means that exit opportunities are available.

In other cases improvements in submarkets or structural changes, such as the trend to last mile logistics, can be the basis of the investment case.

Based on our analysis of global trends in 70 cities and a variety of sectors, we see ongoing potential for the four strategies mentioned above in the current market environment. However, we are cautious about two strategies which have worked well over the last three years. The first is the strategy of anticipating a further fall in capitalization rates, since we believe that capitalization rates have reached their low point in most markets. We also have reservations about investment strategies based on acquiring properties in illiquid locations in order to harvest the higher returns. What some investors forget is that value-added strategies only work when you can exit from the investment successfully. Market liquidity and the presence of core investors as buyers are needed to achieve this.

Matrix of global value-added opportunities

Based on the four strategies we have described, we have identified the following market opportunities on a global basis, which are listed in the matrix below by region and strategy.

### Figure 2: Selected value-added market strategies

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Description</th>
<th>Last 3y</th>
<th>Next 3y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countercyclical</td>
<td>Buying after a market correction in anticipation of a recovery</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Shortage of supply</td>
<td>Investing in property markets with a shortage of space and rising rents</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Improving micro locations</td>
<td>Buying buildings in submarkets which are set to improve in the medium term</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Structural changes</td>
<td>Buying assets that benefit from structural trends</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>High illiquidity premia</td>
<td>Buying properties in illiquid locations to benefit from higher returns</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Yield shift and leverage</td>
<td>Buying core buildings with high leverage. Assumption of falling capitalisation rates</td>
<td>✔️</td>
<td>✔️</td>
</tr>
</tbody>
</table>

Source: Credit Suisse

### Figure 3: Matrix of VA market opportunities by strategy

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Americas</th>
<th>Asia-Pacific</th>
<th>Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countercyclical</td>
<td>Houston office market</td>
<td>Perth and Brisbane office markets</td>
<td>London residential property</td>
</tr>
<tr>
<td>Shortage of supply</td>
<td>Boston, Seattle office markets</td>
<td>Tokyo, Osaka and Seoul office markets</td>
<td>Office markets in Berlin, Munich, Frankfurt and Düsseldorf, Amsterdam, Madrid, UK regional cities</td>
</tr>
<tr>
<td>Improving micro locations</td>
<td>Seattle Bellevue, Boston Seaport, Chicago Fulton, Brooklyn and NY Long Island</td>
<td>Tokyo Shibuya, Seoul Gangnam, Hong Kong, Kowloon East</td>
<td>Paris La Défense and WBD London South Bank, Frankfurt Niederrad and Gallus</td>
</tr>
<tr>
<td>Structural changes</td>
<td>Centrally located residential property in US cities with demographic potential</td>
<td>Korean logistics properties</td>
<td>Private rented sector in UK (PRS) Last mile logistics in continental Europe</td>
</tr>
</tbody>
</table>

Source: Credit Suisse

### Countercyclical strategies

Owing to the positive economic conditions in all regions of the world and the steadily progressing real estate cycle, countercyclical opportunities are currently something of a rarity. They still exist, however, particularly in markets where the recovery has been held back by adverse events or the market has reached the end of the current cycle and is already in a correction. When looking for countercyclical opportunities investors should not only evaluate the current market situation, but to some extent try and anticipate developments in the next 2-3 years, as the capital will be invested over this period (typical investment period of VA products). Further investment opportunities may arise from market changes or unexpected shocks in 2019 and 2020. Particularly in the US we expect a period of weakness and a trend to higher capitalization rates during these two years.

The countercyclical opportunities we currently see in the market on a global scale include cities that are dominated by the commodities sector and have suffered weak demand in recent years. We put Houston (USA), Calgary (CAN) and Brisbane and Perth (AUS) in this category. We recommend focusing on Houston, Perth and Brisbane, as Calgary is a small and not very diversified city.
We also believe that the UK retail market offers countercyclical opportunities, even though we expect the correction to intensify here in 2019. We already saw falling rents, higher vacancy rates and a rise in market capitalization rates by over 100 basis points in 2018. As investment demand has now almost completely dried up, investors have the opportunity to enter the market at yields of over 9%. However, investors must have considerable retail expertise, analyze the tenant mix thoroughly and be strong in asset management in order to benefit from these shifts in the UK retail market.

**Shortage of supply the leading issue**

At present we see shortage of supply in the office markets coupled with continued strong demand from core investors as the main hunting ground for value-added strategies. Construction activity is very low in a whole range of cities globally. It has become difficult for tenants with more demanding requirements to find large amounts of contiguous first-class space in central locations in Paris, Munich, Tokyo, Osaka, Sydney, Melbourne, Boston and Seattle. Markets such as Frankfurt, Amsterdam and Madrid that still had double-digit vacancy rates a few years ago have also seen their vacancy rates decline. Based on supply and demand models we project that the period of low vacancy rates will continue in the coming years, as illustrated in figure 6.

The expected supply of floorspace over the next three years can be inferred from the office projects in progress today, as the completion time for large office developments is 2-4 years. Demand for space, on the other hand, depends on a variety of factors. Economic and labor market conditions in the relevant industries in a particular city are clearly very important. In this regard we expect a significant slowdown in the global economy in the coming years. On the other hand we are observing a trend towards co-working in many markets globally due to technological change. Depending on the city, between 5% and 15% of demand in 2017 and 2018 was accounted for by co-working providers.

**Figure 4: “Commodity cities” have experienced weakness in rents**

Rent in local currency per sqm

Figure 4 shows that rents have undergone a significant correction, although they have stabilized in Brisbane and Perth in particular. At the same time prices in the residential property markets in Sydney, London, Toronto and Manhattan have begun a correction, especially in the higher-end segments. Even if looks a little too early to take the plunge into these markets, we expect attractive investment opportunities here in the coming years. As these are residential property markets, the question is how a VA investor can benefit. We believe there will be opportunities to acquire development projects from residential property developers at lower prices or to participate in such projects via JVs or preferred equity stakes. What we are seeing is that the fall in prices is having an impact on the valuations of these development projects. Many market players have been working on the basis of over-optimistic assumptions and now urgently need capital partners.

**Figure 5: Residential property prices in global gateway cities**

We also believe that the UK retail market offers countercyclical opportunities, even though we expect the correction to intensify here in 2019. We already saw falling rents, higher vacancy rates and a rise in market capitalization rates by over 100 basis points in 2018. As investment demand has now almost completely dried up, investors have the opportunity to enter the market at yields of over 9%. However, investors must have considerable retail expertise,
investors this market environment offers opportunities to realize changes in property use, as the rise in market rents should continue in the locations we have selected.

Improving micro-locations

Cities change continuously, whether through demographic changes, the growth of new industries or infrastructure projects. An example of this, which Credit Suisse Asset Management Global Real Estate was able to exploit successfully, was the purchase of a property in Shoreditch in London in 2014. When we bought the property this micro-location was still a modest B location in London. But its growing popularity within the technology sector turned the submarket into a trendy quarter and a center of innovation. The return generated on the sale of the property in 2018 was well above what had been assumed, in spite of Brexit.

We believe that similar potential will be on offer globally in the coming years and have listed various examples of potential improvements in micro-locations in our matrix (Figure 3). We are keeping a lookout for improvements in locations resulting from infrastructure buildouts. Locations near new or extended rail stations (NY Penn station, Tokyo station, UK Crossrail, London Paddington station) or the gentrification of districts close to rail stations, such as in Frankfurt and Munich, can produce attractive returns.

Exploiting structural trends

We have also identified the logistics sector as a beneficiary of structural change. The growing trend towards online shopping, which is only in its infancy in some countries, leads to rising demand for logistics facilities. Logistics properties, which historically rarely saw rising rents, experienced rental increases of around 4%-5% p.a. in the US and UK between 2015 and 2018. Even if the experience of the Anglo-Saxon countries cannot necessarily be generalized, we believe that many countries, particularly Germany, northern Italy, Spain and Korea are lagging behind in this trend and have potential for catch-up.

The implementation of so-called “build to suit” logistics properties promises further potential for value-added returns. In these kinds of transactions a property is jointly developed specifically for one particular tenant. The tenant usually signs a longer-term lease. Due to the very high investor demand for logistics properties currently, the property can be sold to core investors after it has been built. As well as in the US and UK, there are opportunities in a number of regions in Europe, particularly northern Italy, Poland, Spain and Germany, and also in Asia. One notable example of lagging behind the global logistics trend is South Korea, where net yields of logistics properties have risk premia of over 300 basis points vis-à-vis core office properties. In other markets these premia are between 50 and 150 basis points.

The final structural topic we want to highlight is the trend towards renting properties in countries where there has traditionally been a preference for buying. This is particularly the case in the US and UK, but we also expect stronger demand for centrally situated residential rental space in a number of conurbations in Asia-Pacific. In the US the trend towards renting took off following the financial crisis. It is the result of continued restrictions on the availability of residential mortgages and the large financial losses suffered by many households during the sub-prime crisis. In the UK the lack of affordability of residential property and the shortage of land for residential construction projects are important factors in the trend which has only come to the fore in the last three years. These financial arguments are also being reinforced by socio-demographic changes. Firstly the younger generation (millennials) displays a strong preference for sharing rather than ownership. Secondly, people’s desire to live in a community is growing in spite of digital communication technology, which promotes urbanization. As the UN’s forecasts for the biggest cities in the US and Canada illustrate, the population of many cities is expected to grow strongly in the coming years.

If VA investors are able to create centrally located residential space, possibly in connection with mixed forms of use or student accommodation, this is likely to meet with robust demand.

Figure 7: Strong population growth expected in North America

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>New York-N. Jersey</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Chicago</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Houston</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Seattle</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>San Francisco</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
</tbody>
</table>

Sources: UN Population Prospects, 2018 Revision, Credit Suisse

Conclusion: global focus and combination of different market strategies recommended

- The advanced economic and real estate cycle in many countries represents both a risk and an opportunity for value-added investors. Investors and managers who concentrate on individual regional niches are unwilling or unable to vary their investment strategies over the cycle facing dwindling sources of return.
- Investors and managers who exploit investment opportunities on a disciplined basis globally using research and local expertise will have access to a wider range of opportunities. We recommend combining investments in different markets and strategies in value-added portfolios.
- Continuing shortage of supply in selected office markets in the US, Europe and Asia-Pacific creates a good basis for repositioning and upgrading properties and rising rents.
- Countercyclical strategies are limited to commodity-related cities, residential property in global gateways and UK retail in the current environment. It should also be noted, however, that the investment period for value-added strategies is typically 2 to 3 years. On this basis we anticipate that a number of countercyclical investment opportunities will appear in 2019 and 2020. This applies particularly in the US, where we expect a rise in capitalization rates.

The disclaimer at the end of the document also applies to this page.

Source: Credit Suisse Asset Management Global Real Estate
Anticipated improvements in micro-locations – backed up by infrastructure projects – and the rising demand for logistics space and rental properties are further investment themes that can be accessed by value-added investment strategies.

But investors need to remember that the higher returns targeted by value-added strategies also entail higher risks than core investments. A long-term investment approach and the capacity to tolerate higher risks on the part of investors are required for these investments.