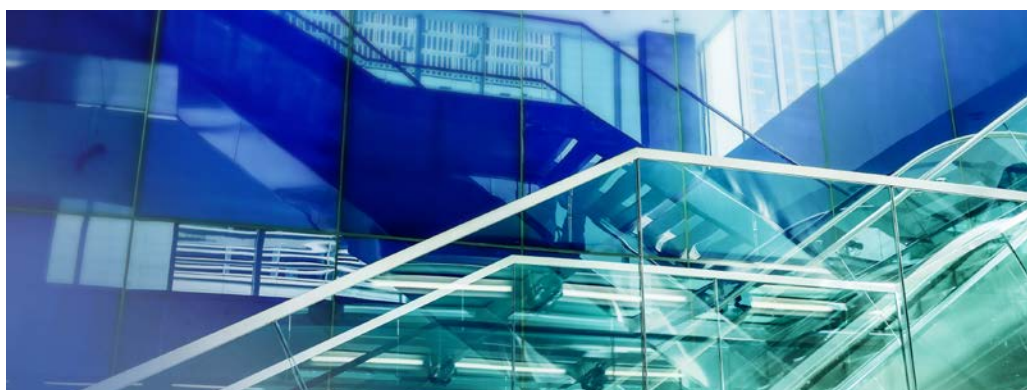


October 2019

Real Estate Strategies: A global look at «value-added» strategies amid sharply lower bond yields

Welcome to the latest edition of Real Estate Strategies:

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- Real estate rental markets performed positively in the first half of 2019 in the US, APAC and Europe despite slower global growth.
- Continuing limited construction activity and solid demand for prime office space continues to support the outlook for further rental growth in all these three regions. We remain positive on many logistics markets as well, while we would recommend remaining on the sidelines for retail assets with some exceptions.
- Due to a significant downward shift of bond yields investment interest has intensified in 2019 for both value-added and core real estate deals. Real estate currently seems to be «the best kid in town» due to its lower volatility than stocks and yield spreads that are higher in some markets than after the correction of prices during the GFC.
- The prospects for value-added investments have improved for the US. Entry prices are today often lower than twelve months ago, while the economic and rental market outlook is solid in our selected cities. We prefer investments in low-supply markets such as Boston, or tech-related markets such as Seattle, the San Francisco Bay Area and Austin. Houston, a market in which prices have corrected substantially, also offers rebound opportunities.
- In the UK, some tail risks remain due to the probability of a hard Brexit. (The Credit Suisse house view indicates a probability of 20% of a crash-out Brexit). If such a scenario can be avoided, we believe UK real estate offers strong value opportunities.
- Office markets in the lion's share of Europe ex UK major cities markets continue to be characterized by low vacancy rates, under-rented assets and further upside for market rents. The competition for assets has increased and some investors are currently overpaying, since they price value-added deals more like core deals. A strong network, deep market knowledge and superior real estate research and analytical skills are necessary to find the right deals and sort out the bad apples.
- Rental markets in Japan, Korea and Australia remain on track and are expected to recover further. Competition for value-added deals has intensified but we continue to see opportunities in cities such as Brisbane, Melbourne, Tokyo, Osaka or Seoul.
- Due to the some higher macro downside risks, we recommend that investors diversify globally instead of investing into regional or niche value-added strategies. Combining assets between different regions improves the risk-return profile of the portfolio.

This issue of Real Estate Strategies provides an update on the investment themes highlighted in our paper «Value-added strategies: global opportunities for the value approach», published in February 2019.

The case for global value-added strategies

We continue to believe – as described in February – that two types of diversification can make the risk-return profile of value-added strategies more robust. Firstly, we would recommend constructing value-added portfolios consisting of investments in hand-picked highly transparent and liquid cities in North America, Asia Pacific and Europe: regional diversification remains important. Secondly, investors need to question the sources of target returns and which strategies are supported by the current market environment. In Table 1 we have categorized value-added strategies into six different market strategies.

Table 1: Selected value-added strategies

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

Source: Credit Suisse

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.

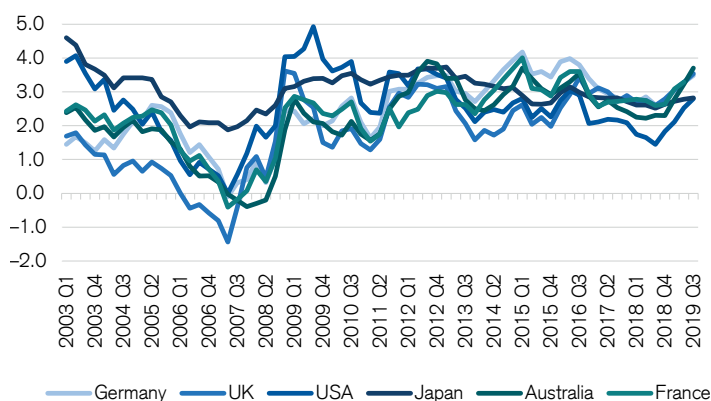
It is a different picture in the second case of a shortage of supply. Here, prices have typically already risen sharply, as the cycle is usually in full swing. Vacancies and the low level of construction point to a continuing shortage of supply. As a result, capital-intensive building measures or a complete 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. We think that the first four aforementioned strategies still have the potential to deliver the typical target returns investors are seeking. However, we are cautious about two strategies that

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 are near their low point in most markets, even as the latest interest rate moves are probably leading to more downward pressure on cap rates. 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.

Broadly lower bond yields provide further support for real estate values

We already highlighted in February 2019 that the global economic cycle was in an advanced stage. Over the last six months, global economic momentum slowed further and the uncertainties relating to a US-China trade conflict have brought some particular weakness for manufacturing activity in predominantly export-oriented countries, such as Germany, Korea and Singapore.

Figure 1: Prime office yield spreads versus government bonds in %



Sources: PMA, Eikon, Credit Suisse

Last data point: Q3 2019

GDP growth slowed substantially in China and Australia as well. However, other major countries such as France, Poland or the US seem to be more resilient and reported rather solid investment and consumption activity.

Inflationary outlook has dipped globally, and central banks have already responded aggressively by cutting rates (US and Australia both by 50 basis points (bps) over the last 4 months) or introducing more expansionary measures like the ECB (with a rate cut of 10 bps announced in September).

Thus, government bond yields declined substantially over recent months. As of the end of the third quarter of 2019, US ten-year government bonds were trading at yields around 1.7%; twelve months ago they were yielding around 3.2%. Australian government bond yields dropped from 2.7% to 1.0% in the same period. German ten-year bunds are yielding deeply negative with a yield to maturity of below -50 bps p.a.

The lower interest rates are positively impacting real estate markets in two ways. Firstly, mortgage rates have come down due to lower swap rates. In addition to this, we observed downward pressure on financing margins where banks are challenged by negative interest rates, resulting in a compression of margins. That enhances the leveraged returns investors can achieve for value-added strategies due to the very low mortgage costs.

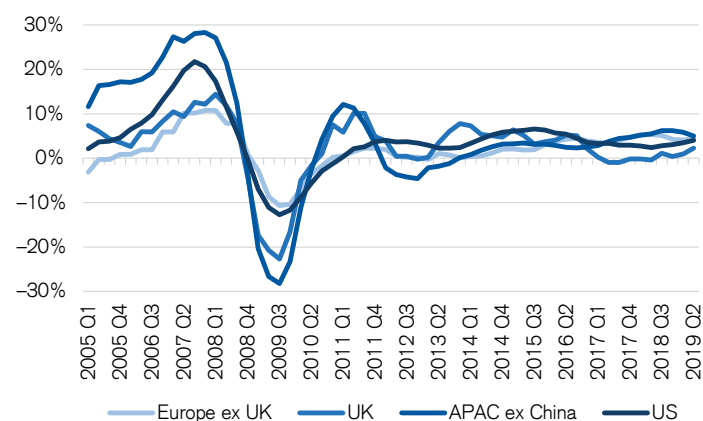
Secondly, risk premia for real estate increased. As seen in figure 1, prime yields spreads in the Eurozone, UK and Australia were above 350 bps at the end of the third quarter of 2019, and even in the US, they have recovered to almost 3%. By historical comparison, the spread between the yields in commercial real estate and government bond are in the upper quartile. Even as property yields are at all time low, property looks to offer good value for investors due to the sharply lower bond yields.

Office rents continue to rise around the globe

Despite the slowdown in the manufacturing sector, office real estate markets continue to be supported by robust leasing activity. For real estate, the evolution in the service sector as well as on the labor markets is more important than industrial or manufacturing activity. Unemployment rates remain at their historical all-time lows in many countries and service sector purchasing manager indices are suggesting that activity in the service sector remains supported.

Figure 2 shows that prime office rental growth remains pretty solid in all major regions. In the US and Europe ex UK, office rents grew between 4.0% and 4.5% in the second quarter of 2019: a strong momentum considering the length of the current cycle.

Figure 2: Growth of prime office rents YoY globally



Sources: PMA, Credit Suisse

Last data point: Q2 2019

Rents in APAC ex China slowed down somewhat but have continued to outperform the other region with a growth rate of 5.0% YoY in the second quarter of 2019. In the UK, rental growth has been weak, but has since accelerated to 2.0%. One structural factor that is still driving the demand for office properties is the trend toward flexible offices. In markets such as London and Manhattan, providers of flexible space are already the largest tenant: flexible space providers took up 15%–20% of annual take-up figures over the last three years.

As widely reported in the media, WeWork has adapted its growth strategy after the changes in its management and the botched IPO attempt. It now looks more likely that the company will follow a more cautious strategy and provide less impetus for rental markets than in recent years. We believe that this is better for current landlords, as the company tries to move to a more sustainable business model. At the same time, we believe that co-working is a business model that is here to stay, and we continue to project further growth in the sector even though some of the hype may be gone.

In the following, we will cover each region in more detail.

US: Relief from the interest rate improves market profile

The US commercial real estate market was in a pretty difficult position in the fall of 2018. As ten-year government bond yields were around 3.0–3.2%, the spread to government bonds indicated that a repricing to higher cap rates might be around the corner (see figure 1).

Table 2: Capital value growth for cities and segments

| Q2 2019 YoY | All | Retail | Office | Logistics | Multifamily |
|-----------------|------|--------|--------|-----------|-------------|
| Atlanta | 2.8 | -5.2 | 6.9 | 6.3 | 3.9 |
| Austin | 4.6 | 2.8 | 7.1 | 5.7 | 3.8 |
| Boston | 4.0 | -10.0 | 5.5 | 7.6 | 4.1 |
| Chicago | -0.6 | -8.0 | 1.7 | 4.0 | -2.1 |
| Dallas | 1.4 | -3.6 | 1.3 | 6.3 | -0.2 |
| Denver | 2.3 | -7.6 | 3.6 | 9.7 | 3.4 |
| Houston | 0.2 | -2.1 | -2.9 | 6.4 | 2.4 |
| Los Angeles | 3.6 | -2.7 | 2.3 | 11.8 | 3.5 |
| Miami | 1.7 | -0.7 | 0.7 | 7.1 | 0.7 |
| New York | 1.4 | -4.9 | 0.4 | 10.1 | 0.7 |
| Philadelphia | 1.0 | -4.0 | -1.5 | 10.1 | -1.4 |
| Portland | 3.1 | 1.2 | 1.0 | 13.7 | -0.5 |
| San Diego | 2.5 | 0.8 | -1.4 | 10.3 | 3.5 |
| San Francisco | 5.8 | -1.6 | 7.3 | 11.4 | 2.3 |
| San Jose | 4.6 | -0.2 | 5.3 | 8.6 | 6.1 |
| Seattle | 6.0 | -0.4 | 6.3 | 12.8 | 1.6 |
| Washington D.C. | 0.2 | -3.6 | -0.8 | 5.3 | 2.3 |

Sources: MSCI, Credit Suisse

Last data point: Q3 2019

Green indicates capital value growth >3%, yellow between 0% and 3% and red negative capital value growth YoY.

Additionally, the construction pipeline has increased and rental growth was slowing down.

This has led to a couple of quarters with particularly poor transaction activities over the last nine months. We also observed some upward pressure on cap rates in some regions, particularly in NY, Philadelphia, Chicago and Houston, and some deals did not go through due to a wide gap between offer and bid pricing.

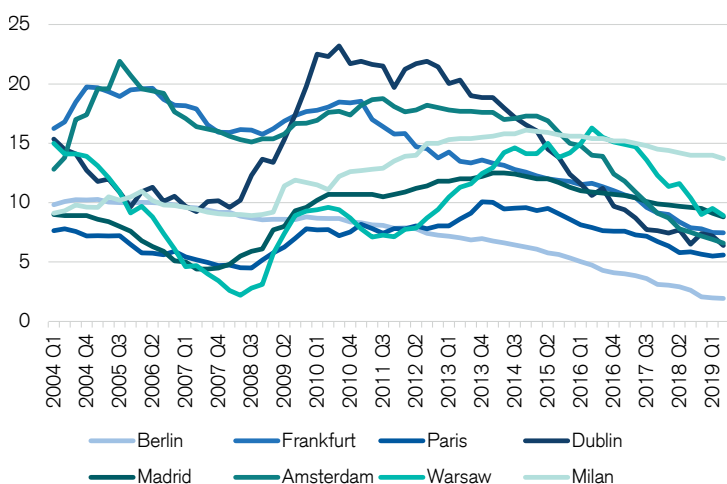
The sharp fall of interest rates and bond yields and the better-than-anticipated demand, predominantly from the tech segment, alleviated some of the upward pressure on cap rates and as highlighted, rental growth also accelerated again. There are substantial differences between markets.

Table 2 shows the change of values as of the second quarter of 2019 by city and segment. Retail properties are weak across the board and are likely to see weaker cash flows and higher cap rates. On the other hand, logistics and industrial property values are appreciating at high rates. For the office and multifamily segment, the situation is more mixed. It is important to focus on those markets with some prospects and on submarkets that are likely to see some improvements. On the office market, we continue to favor the Boston area and some markets that positively benefit from the growth of the tech segment, such as Seattle, Austin, or the San Francisco Bay Area, even as in the latter valuations are more stretched. In the residential segment, the LA and Boston areas continue to have strong fundamentals. In general, we believe the adjustments in pricing in some office markets together with the solid rental market continues to create an interesting investment case for risk-taking in the US.

Europe ex UK: Low supply to provide further support but tricky capital market

The European office market continued to impress despite weaker economic growth. Office vacancy rates continue to decline in an environment of continued limited construction activity and solid demand.

Figure 3: Office vacancy rates by city



Sources: PMA, Credit Suisse

Last data point: Q2 2019

The strongest decline of vacancy rates over the last 24 months was experienced in cities such as Warsaw, Amsterdam and Frankfurt over the short term. Markets such as Berlin, Munich and Paris CBD have already a vacancy rate lower than 2%, but even in these cities, vacancy rates compressed further. This led to a further uptrend in rents.

Construction activity has increased in some cities such as Berlin, Paris and some regional French cities, but remains very limited in markets like Munich and in Dutch cities. We therefore project that the current rental growth of 4% p.a. on average is likely to slow down only marginally and we would anticipate a positive rental growth of over 3% in 2020 and 2% in 2021 for this region. We see the strongest upside in Milan, Dutch cities, Munich and Cologne. However, we believe that in France, Germany, the Netherlands, Ireland and Poland, markets continue to be further supported. For value-added properties, the upside for NOI growth is typically stronger than simply the growth of market rents, as most properties have older rental contracts that are below current market rents. When they expire they will be renewed at higher rents.

As outlined in more detail in our papers from February and June 2019, we continue to remain positive for logistics rental markets as well, as the shift toward online retail creates further opportunities. France, Poland, northern Italy and some Dutch cities are our favorites. At the same time, we would still be very cautious on some of the retail properties, as values also started to correct as we already projected last year.

However, the biggest challenge for European value-added investors is not the market prospects, but the weight of the capital driving up values further. The increasingly negative interest rate environment has pushed European competition for assets to a new dimension. We believe that some foreign investors are overpaying and will not be able to achieve their targeted returns. This means that the network to secure deals and the analytical skills to be able to distinguish value opportunities from overpriced deals is crucial to being able to deliver on the target returns.

Source: Credit Suisse Asset Management Global Real Estate

Historical performance indications and financial market scenarios are no reliable indicators of future performance.

UK: Value opportunities amid hard Brexit tail risks

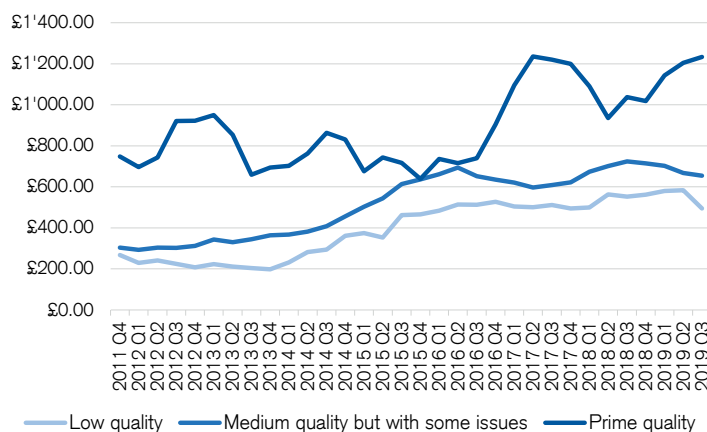
While hard Brexit risks remain in focus for many pundits, the situation on the real estate market with the exception of the retail segment and prime residential properties in London has remained robust.

The supply of new office space has been somewhat higher in recent years in London than in other European cities, but demand from tech tenant or co-working has been particularly strong and also compensated for the weakness of some international financial institutions. Office rents were somewhat under downward pressure but only declined by 5% since they reached the peak in 2015. We anticipate another downside of only 2% for prime London office rents over the next two years in the event that a hard Brexit can be prevented.

Commercial real estate transaction volumes for the UK have declined in the first half of 2019 by roughly 30% YoY but a strong presence of Asian buyers since the Brexit referendum has prevented prime London office values from falling. Prime office deals for assets with longer rental streams are still concluded at peak prices on a per-square-foot (psf) basis. We have been observing prime deals concluded at prices between GBP 1,400 and GBP 2,800 psf and at net initial yields between 3.75% and 4.5% over the last four months.

Figure 4 illustrates that median prices for prime quality assets have increased over recent quarters. As also highlighted in our earlier research, there is still a considerable gap between prime-quality and medium-quality buildings in London. This gap continues to open opportunities for value-added investments in London, as with the appropriate asset management and capex measures the profile of buildings can be improved and sold to core investors at substantially higher pricing.

Figure 4: Do not “mind the gap” in London office median transaction prices in GBP psf



Sources: Costar, Credit Suisse

Last data point: Q3 2019

Data is computed as the moving average of the last four quarters of median transaction prices. Low quality indicates Costar building rating 1-2, Medium quality a Costar building rating of 3 and prime quality a Costar rating of 5.

For regional office markets, the situation has improved over recent years; vacancy rates came down significantly and rental growth has been positive. This is largely because of the very limited supply. As a side effect of the Brexit uncertainties, financing terms had been tightened. The result is now a rental market that is facing limited availabilities. While the situation depends on individual markets, we are now looking for some limited positive market rental growth over the coming years.

Yields are now higher. Investors can achieve a yield spread of more than 500 bps for core deals in markets such as Birmingham, Manchester, Edinburgh or Glasgow, one of the strongest yield spreads we see globally.

Meanwhile, the retail market has continued to weaken in 2019 and rents are down by 10–15% YoY as of August 2019, while cap rates are rising. The insolvency of the travel package operator Thomas Cook adds another worry on the back of an already weak retail market. Costar reports that the company had over 546 retail locations across the UK. With negative news piling in week after week, for us it is still too early to call the bottom for the UK retail market.

The logistics market has remained strong due to the shift toward online retail and annual rental growth continues to remain dynamic. As of the end of the second quarter of 2019, Costar reports a rental growth of 5% around YoY for the UK average. Yields have declined here substantially over recent years and, in London or at prime logistics hubs in the golden triangle, are often below the yields of prime office properties. As vacancy rates are around 3% we continue to project that rents will continue to move higher. Another 10% rental upside over the next three years does not seem unrealistic to us.

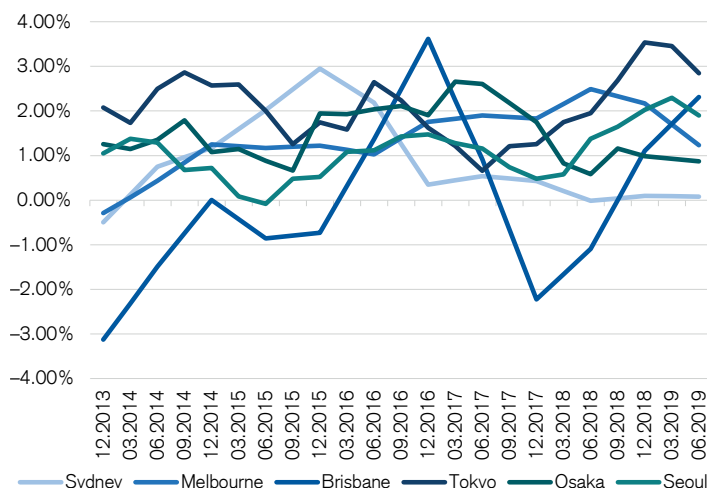
All in all, we believe that compared to bonds and other European markets, UK real estate still offers some of the best value for money for value-added investors. This assessment is still conditional on the assumption that a no-deal Brexit can be avoided. The Credit Suisse house view indicates a probability of 20% of a crash-out Brexit. Under the adverse scenario, there will likely be some short-term downside for rents but we believe that the high risk premia will compensate investors for at least some of that political uncertainties.

Asia Pacific: Office rental markets on track while yields remain under downward pressure in AUS

There are different ways to invest into value-added projects in APAC. Our recommendation to investors is to focus on transparent real estate markets and a low supply situation such as Japan, Australia and Korea rather than going to emerging markets, as value-added investors need an exit and that is more probable in «liquid» markets.

Figure 5 shows the evolution of net absorption (the net demand of space in a market) as percentage of total stock in some major cities in these three countries. Despite a substantial economic slowdown, net absorption has remained robust in these cities in the first half of 2019. Sydney is somewhat of an exception as the rental cycle is here more advanced. Brisbane has been more volatile due to the importance of the resource segment.

Figure 5: Net office space absorption has remained positive in our key cities



Sources: PMA, Credit Suisse

Last data point: Q2 2019

The line shows the annual moving average of net absorption as a % of office stock.

In addition to this still-solid demand trend, supply has remained limited and vacancy rates are under downward pressure. In Osaka, office stock shrank in three of the last four years, while vacancy rates have declined. This means a strong upside on rents. In the second quarter of 2019, office rents increased in Osaka by 7.5% YoY. Rents are also on an uptrend in Tokyo and increased 6.4% in the same period. In Australia, rental growth is slowing down in Sydney but is still at a 7.9% increase YoY. Melbourne recorded a growth of around 5.9%.

In Brisbane, where effective rents have declined since 2011 by 25%, we believe the rental cycle is in an interesting stage and rental growth has also turned positive (in the first half of 2019, YoY office rental growth was at 2.4%). Here, we anticipate some more recovery as vacancy rates are likely to decline further.

In Seoul the rental market has also remained stable and rents are growing around 3% p.a.

To summarize the APAC markets, we believe that they remain on track and provide a fertile soil for value-added investments. Similar to Europe, the capital market is heating up and the competition for deals has increased. This was most noticeable in Australia, where the 50-bps cuts in interest rate and historically low bond yields at around 1% are making more and more investors turn to commercial real estate.

Key takeaways

Despite the weaker global economic prospects, the situation in the real estate rental market remains solid. The limited construction activity in many major cities is an important positive factor. Many office markets are undersupplied with prime modern space, while urbanization and the trend toward flexible office solutions (despite the changes at WeWork) continue to provide a structural tailwind for demand for such an offering. We continue to recommend focusing on markets where there is further rental growth and the option to buy "under-rented" properties. In our view, the outlook has improved for the US due to better entry points than twelve months ago. We believe UK assets (with the exception of prime London office deals) are underpriced in a relatively global comparison. Pricing in the UK is certainly bound back by the hard Brexit risks. As highlighted, the rental market outlook also supports further

opportunities in Europe ex UK, Japan, Korea and Australia. Selectivity remains key in all these markets due to the weight of the money and strong competition for deals. However, we would expect further global weakness in the rental and capital market for retail properties in both Europe and the US, due to the shift of consumer preferences for online and mobile shopping. On the other end, logistics properties continue to benefit from the shift toward online retail and this can also be exploited in value-added portfolios. We see potential in several European markets, such as France, Poland, the UK and northern Italy. The US market is also going from strength to strength, while we already identified logistics in Korea as a space still relatively unexplored by most institutional investors in our February issue. With the more economic risks tilted to the downside, we continue to believe that a global rather than a regional focus is an appropriate strategy to manage risks for value-added investments.

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