EUROPEAN VALUE-ADDED INVESTMENTS:

A VALUE APPROACH CONSISTENTLY APPLIED TO REAL ESTATE

In our view, the current environment in Europe remains favourable for value-added investments. Our opinion is that a selected basket of investment themes that encompasses exposure to German development and vacancy risks, underpriced UK regional assets, and investments in markets that lag the global cycle provide the most meaningful perspectives for value-added returns. Deal selection and asset management skills remain key.

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THE IMPLEMENTATION OF A VALUE APPROACH IN VALUE-ADDED INVESTMENTS

Investors are familiar with the approach of "value investing" in stocks and bonds. This investment philosophy was established by Benjamin Graham and David Dodd in their legendary textbook "Security Analysis" published in 1934, and it is also applied by famous, successful investors such as Warren Buffett. This principle aims to find assets that are underpriced by means of research analysis of company or market fundamentals.

We believe – based on our long-standing track record that goes back to 1938 – that value investing can be successfully applied to real estate investments, particularly for value-added strategies. We believe that the identification of market themes through research, finding assets that are underappreciated by other investors, and consistently executing on those strategies with strong teams on the ground build the basis for the generation of value added return. A constructive dialogue and cooperation between researchers/strategists who follow a top down approach based on the analysis of market fundamentals and asset managers, acquisition and financing specialists who bring in the bottom-up perspective is key. This implies not always going with the flow but focusing on high-conviction themes.

STILL A GOOD POINT FOR VALUE-ADDED INVESTMENTS IN EUROPE

Europe has seen an eventful decade with regard to economic performance, shifts in the political landscape, and turns in the real estate markets. Since mid-2013, the economy and real estate market have been recovering, albeit with significant differences between countries. Due to the quantitative easing policies of the ECB, however, income yields for core real estate assets have generally compressed. This means that the low-hanging fruits of playing a downward shift of yields of core assets to generate higher returns have been reaped. That is why at the current point in the cycle, value-added returns need to come from the identification of markets or assets with upside in cash flows, and from the manager's ability to find underpriced deals and execute on asset management and development strategies. However, we wouldn't recommend focusing on a single country or segment but would recommend having exposure to a basket of the following four themes, as we believe that diversification is also an important risk management tool for European value-added investments.

a) Benefit from the low construction activity and persistent rental recovery in Germany

Due to stable economic performance and low construction activity, office vacancy rates have declined substantially in recent years in Germany. Demand for commercial space has become somewhat stronger but a disciplined supply response has contributed a lot to the current situation, in which rents have started to increase. Despite the recovery in fundamentals, we forecast a persisting low vacancy rate environment for the major German cities over the next years. Figure 1 highlights that we forecast the office average rate for the German top-7 cities to remain at their current level of only 6%, as net additions are expected to remain below 1% for the next two years. This should pave the way for a growth of market rents of 2-3% in most cities over the next few years. Thus, we believe that the risk-return prospects for taking well-balanced development and vacancy risks in Germany warrant the investments in these higher-return strategies. However, asset selection and the analysis of micro-location remain key success factors. Real Estate of Credit Suisse Asset Management is present in Germany since 1992.

b) See the post-Brexit higher yields for value-added assets in the UK as an opportunity

The best possible business case for value generation often arises when a large part of the investors avoid some markets/assets but there is deep embedded value in them that only a few recognise. That was the case in US commercial real estate in 2009, or in 2012 in Dublin offices; we entered both markets in those years to the benefit of our investors. We also see a compelling case for investing in commercial real estate markets in the UK outside central London. Brexit has brought weaker pricing for regional UK assets, which hadn't recovered fully from the financial crisis even before Brexit. Based on our analysis, this is also a segment that is likely to be less affected by Brexit-related risks than central offices in London. As we highlight in figure 1, regional UK assets look to be good value for money. Risk premia are not only elevated for value-added regional UK assets compared to government bonds, but also compared to prime London assets. Surprisingly, these relative risk premia are currently higher than during the depths of the financial crisis and reflect a deep underappreciation by most investors. Even if Brexit poses some short term risks for the rental markets, we believe these high-risk premia compensate investors for taking those risks, as these assets will see a recovery over the mid-term.

c) Execute on European laggard plays

In addition to the UK and German markets, we would also recommend mixing some market segments that have so far lagged the global real estate recovery cycle into a European value-added portfolio. In our view, these are Dutch offices, which have only started to see vacancy rates coming down and rental performance stabilising after years of crisis. Pricing has already recovered for prime office locations in Spain or Ireland, but we think that a similar logic also applies to retail, logistics or less central office assets in Spain and Ireland. We believe these markets will be supported by increasing rents, as the economies continue to recover in the coming years and valuations look appealing.

d) Address "political risks" in your European value-added asset allocation

Political risks are also an important factor to consider at this point when constructing a value-added European portfolio. An empirical example is provided by the euro crisis in 2011/2012. The increase of sovereign risks negatively affected real estate performance in the macro-economically weaker countries at that time.

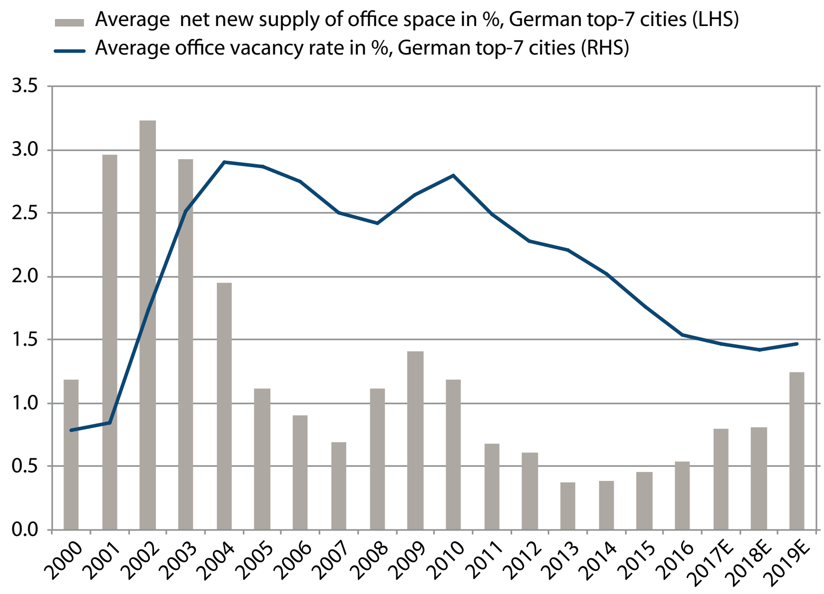
We address political risks in two ways. On one hand, we currently avoid exposure for value-added investments to locations that can be impacted by greater political risks, such as Italy, Portugal or even Paris, where real estate yields are low and bumpy elections loom. Further, the basket of the three themes we discussed above is constructed in such a way that favorable cross-asset correlations can do their work and asset values should prove resilient even as downside risks materialise. A harder type of Brexit is certainly an additional risk, which we address by currently not focusing on the central London market, but rather on the regions in the UK.

On the other hand, these risks provide some positive optionality that can eventually be exploited for the benefit of investors. Cash that can quickly be put to work has this embedded positive optionality. In the case of a correction in any of these markets, investment managers need to have cash at hand that they can employ at their discretion if valuations become attractive. As such, windows of opportunity don't last long; the ability to put money to work quickly is crucial to being able to capitalise on such chances.

KEY TAKE-AWAYS

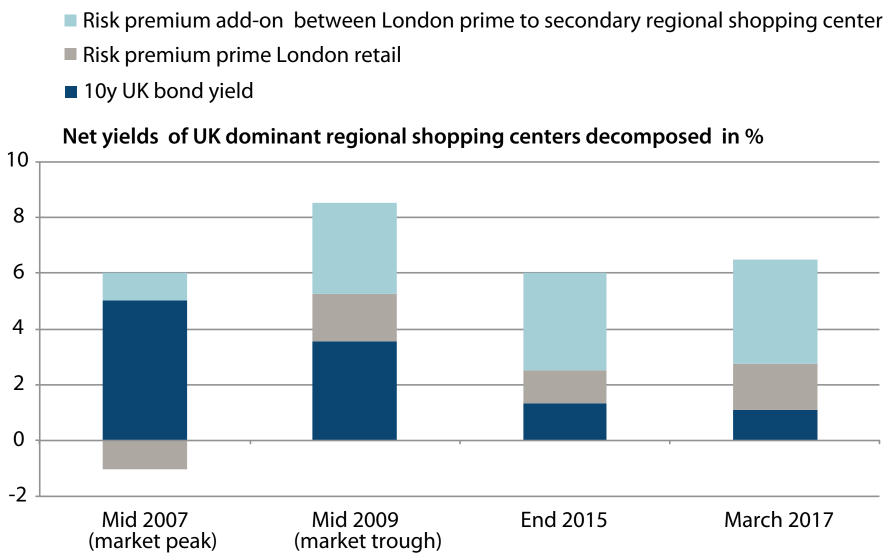
In our view, the current environment in Europe remains favorable for value-added themes for investors who consistently apply a research-based "value investing approach." We at Real Estate of Credit Suisse Asset Management believe that the anticipated positive economic growth and the continuing low supply environment in commercial real estate in Europe should be addressed not via a single country or niche investment but by a basket of different themes described above. Political risks in Europe also need to be factored in to the way in which money is allocated to the different value-added themes; but please bear in mind that a world without risks does not provide the opportunities to deliver value added returns.

Figure 1: Low vacancy rate situation likely to persist



Source: PMA, Credit Suisse Last data point: December 2016

Figure 2: Underappreciated regional UK markets as an opportunity



Source: Cushman Wakefield, Savills, Datastream, Credit Suisse Last data point: March 2017