FOUR QUADRANTS

QUARTERLY INVESTMENT OUTLOOK | DECEMBER 2015

DIVERGENCE OF OPINION AND THE RELATIVE VALUE OF REAL ESTATE

PUBLIC EQUITY
Affected by wider market volatility

PRIVATE EQUITY
Strong fundraising continues

PUBLIC DEBT
Credit spreads widen

PRIVATE DEBT
Pricing and lending terms stabilise

CBRE

Capital Advisors

“While the public equity and debt markets pondered how to price the risk of a Chinese slowdown and to guess what approach the central bankers would take, real estate investment volumes continued rising with further EMEA-wide yield compression reported across the board”

TONY MARTIN
Executive Director
Investment Advisory

INTRODUCTION

RELATIVE VALUE IN THE FOUR QUADRANTS

The most intriguing feature of the real estate asset class is its heavy reliance on non-public capital. In periods like the past quarter, this is perhaps also its best feature.

In the third quarter, public markets, both debt and equity, have had a little rattle as uncertainty about Chinese growth and its impact on the world economy heightened and led to widening credit spreads and volatility in the equity markets.

While the public equity and debt markets pondered how to price the risk of a Chinese slowdown and to guess what approach the central bankers would take, real estate investment volumes continued rising with further EMEA-wide yield compression reported across the board. Economic recovery and shortages of desirable prime space underpinned further gains in rental growth. While the greatest focus remained on the established areas, investor interest into niche asset classes continues to grow.

The volumes of investment were supported by the private debt and equity markets which seem more influenced by attractive real estate market conditions than wider economic and political concerns. The private equity markets, both primary and secondary, continued to book very strong volumes while pricing appears to remain tethered to property fundamentals. Equity providers were supported by the lenders’ appetite – the banks continued to lend and we have seen no evidence of softening in collateral requirements or excessive margin compression.

REIT prices slid early in the quarter as investors initially reacted to the uncertainty affecting sentiment in the wider market. However, the nervousness was temporary and REIT prices quickly recovered to higher levels, perhaps emboldened by the continued confidence in the private markets. The fragile CMBS market was less resilient to the nervous mood with some planned new issuance was shelved.

After a period of relatively benign conditions and an improving outlook for investors, the mixed signals in the quarter to September prompted some reflection and the result was a choppier market. While the ‘lower for longer’ monetary outlook is generally a positive for our asset class, are the reasons for prolonging this policy a cause for concern? And was the REIT investors’ moment of skittishness rational or is the private market investors’ confidence in the fundamentals well founded? Either way, the slight cooling in the last quarter was probably no bad thing.

THE FOUR QUADRANTS HIGHLIGHTS

1. Public Equity

- REIT pricing was impacted by general market volatility; however it continued to outperform wider markets.
- Revision of forward rate and first rate rise date expectations during the quarter aided price recovery.
- Price to book ratios of the major UK REITs have fallen from 1.18x to 1.02x as NAVs outpaced stock prices.

2. Private Equity

- Investors continued to seek European real estate exposure as highlighted by the persistent queues for open-ended vehicles and fund recapitalisations.
- Investor appetite continued to be focused on established management platforms with strong track records and seed portfolios.
- Buoyant secondary market activity was supported by institutional investors' consolidation of significant fund portfolios.

3. Public Debt

- Lower long term rates were the result of increased uncertainty over global growth and mixed messages from central banks.
- Higher credit spreads created a dislocation between public and private real estate debt markets.
- CMBS resurgence faltered with new deal launches slowing and a growing preference for syndication over securitisation.

4. Private Debt

- Lending terms of senior lenders have stabilised both in terms of pricing and collateral thresholds.
- UK clearing banks have become more active in the senior lending segment.
- Mezzanine debt volumes have increased and pricing has come under pressure during the quarter following a wider trend of more competition in this market segment.

MACRO SNAPSHOT

Despite considerable volatility in sentiment during the period the macro overview is pretty consistent:

- UK growth is easing but still robust with construction and manufacturing being sources of weakness, offsetting strength in services.
- Input price falls, especially petrol, saw a return to deflation in the quarter and, with slowing growth and easing wage growth, expectations of rate increases have eased.
- The Eurozone is continuing its upturn but this is slow and low with the expectation that the ECB will increase its QE programme.
- The expectations of a rate rise in the US continue to be a principal focus of markets, as they have been for several years.
- China is slowing, however there is considerable uncertainty regarding the extent of this slowdown due to concerns about the reliability of official figures.

> "The Eurozone is continuing its upturn but this is slow and low with the expectation that the ECB will inrease its QE programme"

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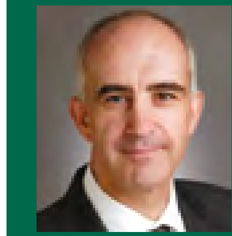


MICHAEL HADDOCK
Senior Director
Research

DIRECT PROPERTY

Investment volumes continue a strong trend

The recent death of Yogi Berra brought to mind two of his famous quotes that seem ideal to describe the current state of the real estate market.

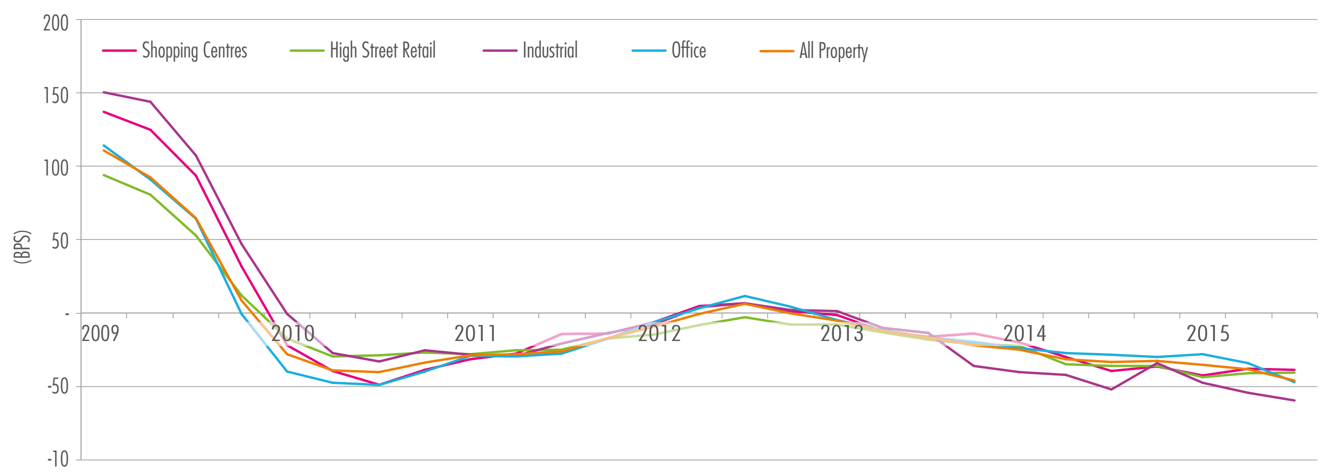
The high level of investment activity brings to mind his famous “It’s like déjà vu all over again”. Yet although there are many similarities between the current cycle and previous ones there are also many differences. The value of commercial real estate product being traded is continuing to grow rapidly and is close to the peak levels of 2007. However, it is evident that the market is deeper than it was then and the proportion of the value transacted that is in ‘alternative’ sectors such as student housing and hotels is much greater now. The use of debt is also growing, but it remains dwarfed by the amount of equity in the market.

Figures for Q3 2015 suggest that the rate of growth in investment is tailing off slightly – down to circa 20 percent per annum from mid-30s percent a couple of quarters ago. However, we have seen a lot of stock coming to market in September and October and this suggests a potentially very strong fourth quarter.

Rate of yield compression increases despite low base

Despite concern from some investors over the low level of yields, recent quarters have seen the rate of decline in yields accelerate. CBRE’s EMEA average prime yield fell by 14 basis points in Q3 to 4.94%. This compares with an average fall of 10 basis points over the previous four quarters. This reminds us that “It ain’t over till it’s over”. In October 2010 the consensus view was that the German 10-year bond yield, then 2.5%, would be back to 3.7% by the end of 2012. Now, five years later, it stands at 0.6%. Differences in opinion are what make a market and there are plenty in today’s market.

Twelve Month Change in CBRE EMEA Weighted Average Prime Yield



Source: CBRE.

GRAHAM BARNES
Executive Director
Corporate Finance

PUBLIC EQUITY

Wider mid-quarter equity market volatility impacts real estate stocks

The market for listed real estate equity during the third quarter has been dominated by a massive wobble in mid-August centred on concerns about China and triggered by a devaluation of the renminbi. During this period we saw UK and European real estate indices off 9% and 12% respectively. We also saw the VIX, dubbed the "fear index" by the more lurid members of the press, reach levels not seen since 2011, rising from a range of 12-15 in the first half of the year to a peak in excess of 40. Real world concerns about the length and nature of the cycle and the drivers of global growth were much to the fore with real estate taking its share of the pain. This was partly due to the fact that recent pricing has been justified, at least in the more fully valued markets such as London, by expectations of rental growth, which would likely be misplaced if there was a real slow down in the wider economy.

REITs recover ahead of general market

This all passed pretty quickly with the VIX now back at around 15 and real estate equities having regained 90-100% of their falls. It is worth noting that concerns about the rate of global economic growth persist and the principal equity indices have not fared so well having regained around 50-60% of their losses. In fact, in common with much of recent history, real estate equities have outperformed wider indices; outperforming year to date, falling by less and bouncing further and faster.

REIT stock return forecasts reflect revised rate rise expectations

One perspective on this is to consider the place of real estate, and real estate equities in the wider context of relative value and capital allocation.

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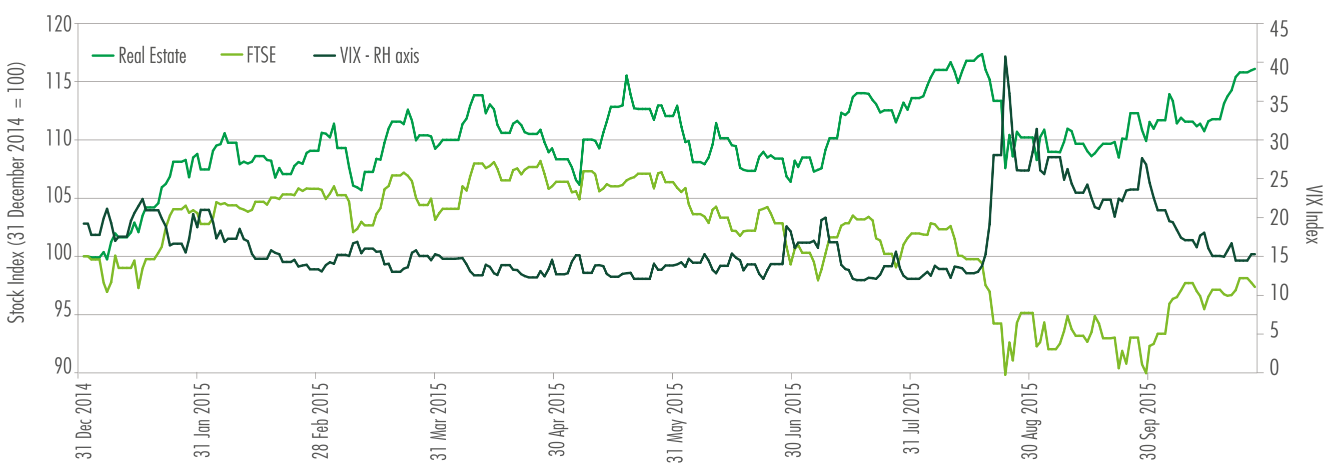
During the first half of 2015, expectations of a short term rise in GBP rates were rising, with the date of the expected first rise moving from July 2016 in January to January 2016 by June. At the same time, projections of forward interest rates were rising, with 5 year GBP swaps forward rising from 1.7% in January to 2.8% in June. This can be interpreted as having damped any upside in equity prices which might have been expected given the rate of increase in net asset values. The UK names were up c.8% in the first half of the year, having pulled back from a high in May, with the price to book ratio declining from 1.18x to 1.02x as rising NAVs outpaced share prices.

In the third quarter the expected date of the first rate rise went out to February 2017 and the forward swap fell to 2.3% with, as mentioned above, equities regaining close to their previous highs.

Recent economic data pointing towards still robust but slowing UK growth, a continued weak but improving environment in the Eurozone and expectations of further QE from the ECB all point towards a lower-for-longer rate environment in a slowly improving economic context, which is being positively received by the real estate equity markets.

Equity Markets vs VIX Index



Source: Bloomberg

"Demand from capital for exposure continues; underlying fund performance remains positive; stable secondary market pricing and increasing liquidity; collectively, it is difficult to paint a more positive picture"

PAUL ROBINSON
Executive Director
Alternative
Investment

PRIVATE EQUITY

Secondary market volumes rise

The third quarter is traditionally a quiet period in European real estate markets. The emphasis, as the Portuguese would put it, is on "deixa vida rolar" - let life roll, and the beach takes priority to business. 2015 seems to have been an exception to this rule, at least in the indirect market.

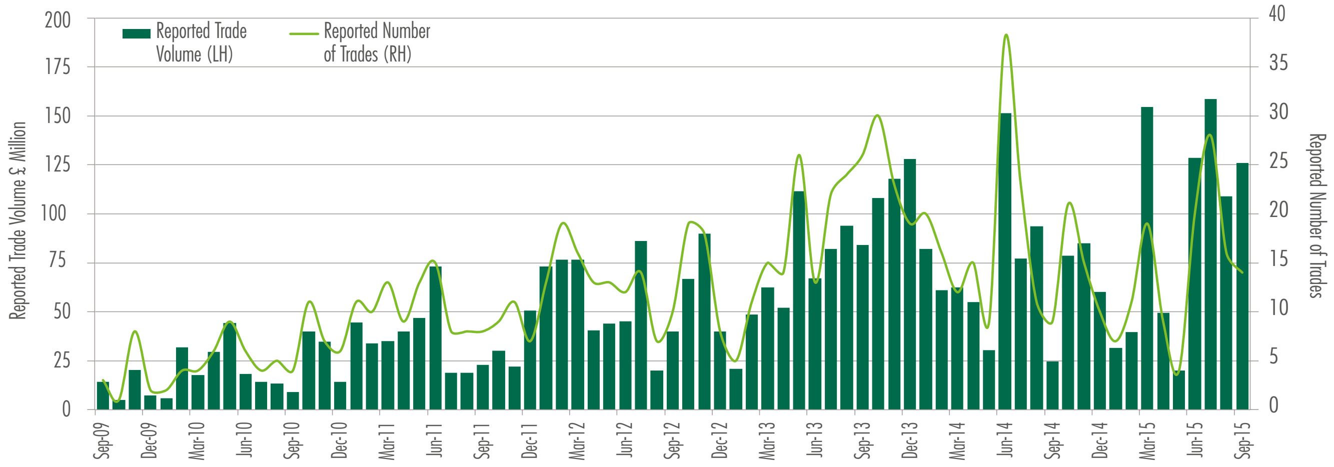
Pricing not impacted by wider market volatility

Our secondary trading platform PropertyMatch reported its busiest quarter since establishment, driven by an increase in liquidity in Continental European funds. Indeed, Euro denominated trades exceeded Sterling denominated trades for the first time, a trend that looks likely to continue into the fourth quarter at least. Unlike public markets the increase in volume was not associated with increasing volatility; pricing has remained quite stable with the majority of trades taking place within a NAV+5%/NAV-5% range, although there are obviously outliers in both directions. So what is driving the increase in liquidity? Broader participation is definitively a theme: many potential sellers have waited a long time for the Bid to Book spread to narrow and are taking advantage of market sentiment to sell into the rally; we also sense currency volatility in 2015 maybe a driver for some sellers. The bid side of the equation remains robust, particularly in Continental Europe where queues for established open-ended funds often run into the hundreds of millions.

Primary volumes are strong

The primary market seems to have had a quieter third quarter in terms of large closings, at least in Europe, but the flow of capital to the sector continues. According to PERE, $107bn has been raised globally in the first three quarters of 2015, a 14% increase on the same period in 2014, which marks a post-crisis record. Of this, $34.6m has been invested in global funds, many of which had closings in the third quarter; doubtless some of this capital will be targeting European markets. For the time being at least, the stars are in alignment: demand from capital for exposure continues; underlying fund performance remains positive; stable secondary market pricing and increasing liquidity; collectively, it is difficult to paint a more positive picture. One is tempted to say "dexia vida rolar".

Historic PropertyMatch Trading Volumes



Source: PropertyMatch

"As a result, the economics of CMBS issuance are still not attractive enough for mainstream commercial real estate debt markets right now"

PAUL LEWIS
Senior Director
Loan Advisory

PUBLIC DEBT

Central Banks turn course

Uncertainty returned to the markets in September as China wobbled and the Fed blinked. In the rates market, we saw UK, US and Euro bonds all rally, driving down rates amidst a flattening curve. A pattern of volatility entered the market in August and looks set to remain stubbornly difficult to shift out of. Conflicting views over the relative direction and importance of the global commodity deflation story, China's slowdown and weakening job growth in the US has caused real and very evident divisions amongst central bankers, particularly the Fed. Conflicting rhetoric is causing many credit investors to lose confidence in the central banks' credibility which is only stoking volatility further.

Credit spreads widen

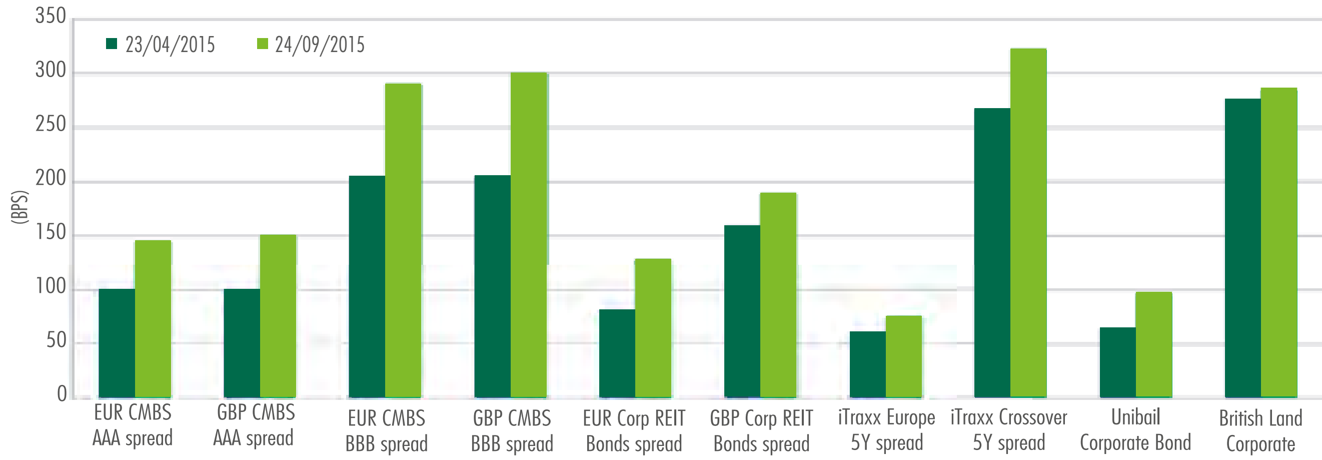
Credit spreads across most fixed income markets have been widening since August, and real estate is no exception. REIT corporate bonds spreads have tracked higher in the secondary market with minimal primary issuance. Interestingly the convertibles have proven more defensive, reflecting a more recent rebound in REIT pricing as investors once again buy into the relatively attractive income yields in a 'lower for longer' environment.

CMBS market hampered

The CMBS market has however suffered disproportionately, with few of the well tracked and anticipated deals not reaching the primary issuance market. As we have highlighted before in this publication, the current regulatory environment is simply not conducive to the development of a broad buyer base for securitised real estate loan products, making them vulnerable to credit market downturns. At the same time, we continue to see strong competition by private debt providers to lend in the most popular spectra of the markets (e.g. 65% LTV, Core-plus / Value-add).

As a result, the economics of CMBS issuance are still not attractive enough for mainstream commercial real estate debt markets right now. That said, all is not lost as we are seeing a demonstrable increase in demand for lending to the more peripheral parts of the markets, which CMBS or other 'bond format' products are better designed for. Examples of such products are bridging loan portfolios, quasi-infrastructure deals, student housing, hospitality and bond-format mezzanine loans. Expect these to be a greater feature of the public debt markets in 2016.

6 Month Yield/Spread Changes



Source: Bloomberg, BAML

"We have seen terms stabilise slightly and lenders holding on terms they have committed to. Many senior lenders have hit or are well underway to hitting their targets for this year"

NUALA CONNEELY
Associate Director
Debt and Structured Finance

PRIVATE DEBT

Lending terms stabilise

The end of 2014 and the early half of this year saw competition between lenders to deploy their capital and tighten pricing to win the most sought after deals, particularly in prime retail and office investment deals. We have seen terms stabilise slightly and lenders holding on terms they have committed to. Many senior lenders have hit or are well underway to hitting their targets for this year and are focussing on 2016 targets and relationships; some are targeting different asset classes to diversify their pools of capital.

UK clearing banks ramp up activity

The UK clearers have become more active of late. Whilst their LTV parameters are on the whole conservative, their loan structuring and relationship driven nature is appealing to a broad range of borrowers. Their staged credit process means that there is less risk of "deal slippage". Many of these lenders need to replenish their targets as loans are being repaid and we see this activity continuing into next year.

Availability of mezzanine debt increases

Availability of mezzanine debt and competitiveness around pricing has improved significantly. There are a significant number of mezzanine lenders in the market who are looking to place large debt tickets and many notable investment deals that have completed recently have up to 85% LTV with a combination of senior and mezzanine. The key for a number of lenders is the counterparty and indeed that the level of equity involved in the deal is sensible. We have not seen LTV's like pre-crisis levels nor do we see this happening in the near future.

Across the vast majority of asset classes mezzanine pricing has become tighter and indeed certain institutions will not participate unless the size of the transaction is above £20m. The majority of the UK clearers and other senior lending institutions have a clear process for working with mezzanine providers, and this process can be quite efficient if the lender has worked with a particular party previously making it less of a risk factor for the borrower.

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