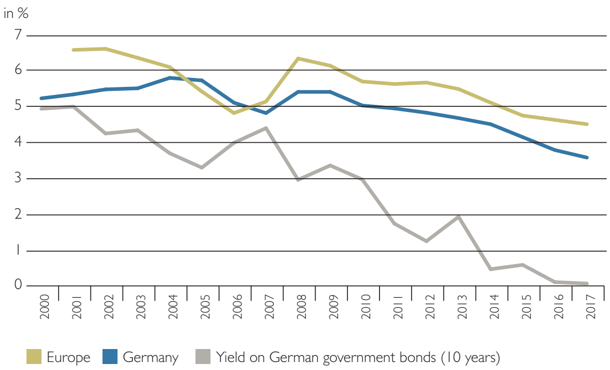
Strong focus on value-add investments

Market environment

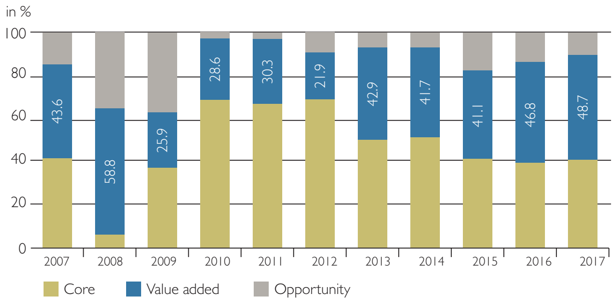
When examining the current market situation considerable interest in “value-add” investments can be observed among institutional investors over the past 12 months – both in the segment of companies previously acting as “core” investors and also among traditionally opportunistic investors. The reasons for this pincer movement are partly company-specific, but there is also another reason at the level of the market: the expansionary monetary policy of the ECB and the FED and the resulting yield compression for conventional investments are leading to increased explanations when yields fall short of the traditional 5% benchmark for real estate investments. For example, the initial net yield for European core office investments in the 19 countries examined below is expected to average at 4.5% at the end of this year. The corresponding figure in Germany is even considerably lower at 3.6%. This represents a roughly 30% decline in initial net yields since 2000.

FIG. 1: PRIME INITIAL NET YIELDS FOR OFFICE PROPERTIES IN GERMANY AND EUROPE



Source: Catella Research 2017, Property Market Analysis (PMA)

FIG. 2: INVESTORS’ PREFERENCES FOR INVESTMENT STYLES/RISK CLASSES



Source: European Association for Investors in Non-Listed Real Estate Vehicles (INREV) Investment Intentions Survey 2017
Presentation & design: Catella Research 2017

Definitions – value-add & asset management

In addition to the inflation of the term “value-add” over the past 20 months, which has become particularly common in press releases and investor reports, it can be seen in particular that the term is often defined differently. The INREV style classification has now become established as a market standard for investors. According to this system, value-add is generally used if:

- the degree of (re-)development is to exceed at least 5% of the gross asset value (GAV)
- there is an LTV (loan-to-value) of more than 50%
- by definition, at least 40% of the value driver for the total return does not come from the current cash flow

Although some basic indicators have seen nominal changes along with the changed interest rate environment in recent years, we still consider this definition to be very useful.

The private equity nature is due to the fact that there are no asset management activities – meaning that earnings generated from current income are not the primary value driver – and the average term of a single-property fund lasts only a few years.

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FIG. 3: SIMPLIFIED STYLE CLASSIFICATION BASED ON INREV

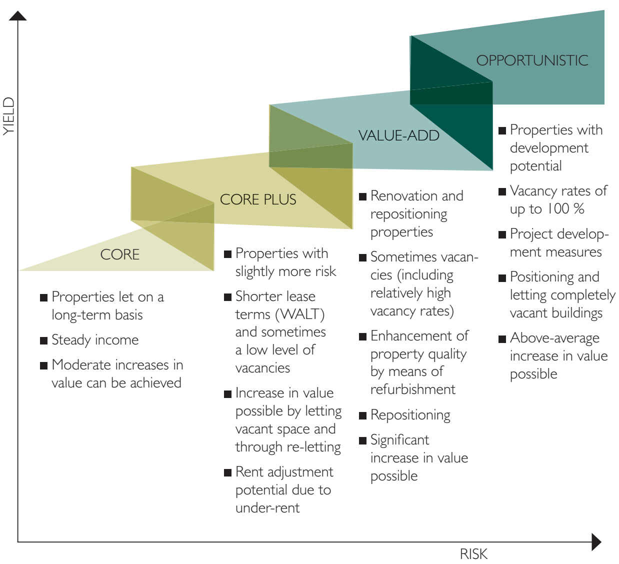
	Core	Value-Add
Current (stabilised) income in %	High	Medium
Development potential as percentage of GAV*	Low	Medium
Leverage	Low	Medium (>50 %)
Target markets	Established cities	Established cities and opportunities
Key risks	Market risk	Market risk, location and letting risks, operational risk, development risk

*GAV = Gross Asset Value

Source: European Association for Investors in Non-Listed Real Estate Vehicles (INREV)
Presentation & design: Catella Research 2017

In addition to this technical and functional definition, however, the asset management function also increasingly requires attention. To put it more simply: for an asset management employee, a value-add classification is associated with more administration and work with the property itself. Often, part of the property is already vacant or there is a risk of potential vacancy due to a low weighted average unexpired lease term (WAULT).

FIG. 4: INVESTMENT STYLES AND APPROACHES FOR ASSET MANAGEMENT



Source: Catella Research 2017

Applying a "manage-to-core approach," ultimately a workable description of the activities for "value-add investments" from an asset management perspective, companies attempt to reposition a value-add property as a core property by means of various active measures. Ideally, a high-quality property in a good location and with a stable letting situation will be achieved as an operational goal. This can be accomplished, for example, by:

– generally improving the letting and earnings situation (letting, cost reduction, refurbishment, etc.)
– repositioning the property by improving the financing structure and bringing about market conformity, e.g. green building quality
– taking advantage of market cycles when selling the property.

FIG. 5: MEASURES FOR OPERATIONAL ASSET MANAGEMENT

Improving the letting and earnings situation for value-add properties	
Letting ■ (Re-)negotiation of new and existing leases – Lease renewals and rent increases – Change from single-tenant to multi-tenant structure	**Greater usability & improvement of property** ■ New workspace concepts (creating new areas, etc., more efficient use) ■ More parking spaces ■ Renovations ■ Improvements
Cost reduction ■ Outsourcing property management ■ Façade insulation to lower energy costs ■ Reducing ongoing operating costs ■ Increasing building efficiency	**Changed property strategy** ■ Change in type of use ■ Change in properties used

Source: Catella Research 2017

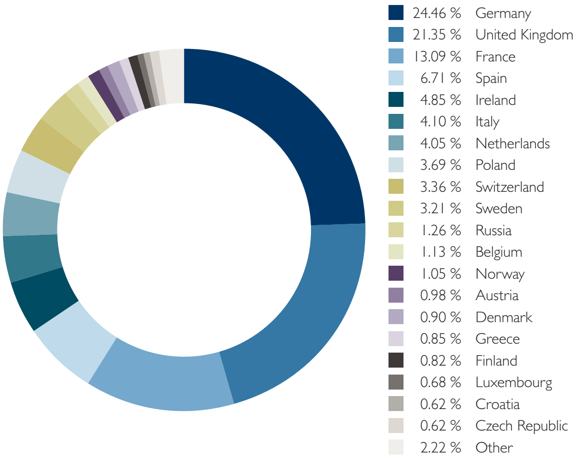
The market for asset management services in Europe

Based on the motives for value-add investments in recent years, the value-enhancing components are already being anticipated in the current purchase price at property level by rationally acting investors. This is consequently giving rise to major value enhancement opportunities in this segment and high sales potential for asset management services. Although general statements can only ever provide an indication and the operational value driver is only to be found at the level of the individual property. Due to the heterogeneous and individual nature of asset management measures, a **market scenario for Europe** is drawn up below:

In 2016, properties with a total value of EUR 256 billion changed hands in Europe in the commercial segment (office, retail, logistics, hotels). Based on the model assumptions and random samples, Catella Research estimates that around EUR 50 billion of this (20%) related to "value-add" properties. Assuming a five-year term for AM services and further market stimulation, we anticipate that an average potential for AM services totalling EUR 6 billion to EUR 10 billion by 2021 can be derived in the baseline scenario. On average, the AM potential thus comes to just under EUR 1.6 billion a year in Europe.

Ultimately, estimates have to be made on the basis of random samples in order to determine the value-add segment's market potential for individual countries. Based on the transaction data saved by Real Capital Analytics (RCA), Catella Research determines that in a comparison of 30 countries across Europe the highest value-add transaction volume in 2016 was to be found in Germany (25%), the UK (22%) and France (14%).

FIG. 6: MARKET POTENTIAL OF VALUE-ADD INVESTMENTS IN EUROPE (2016)



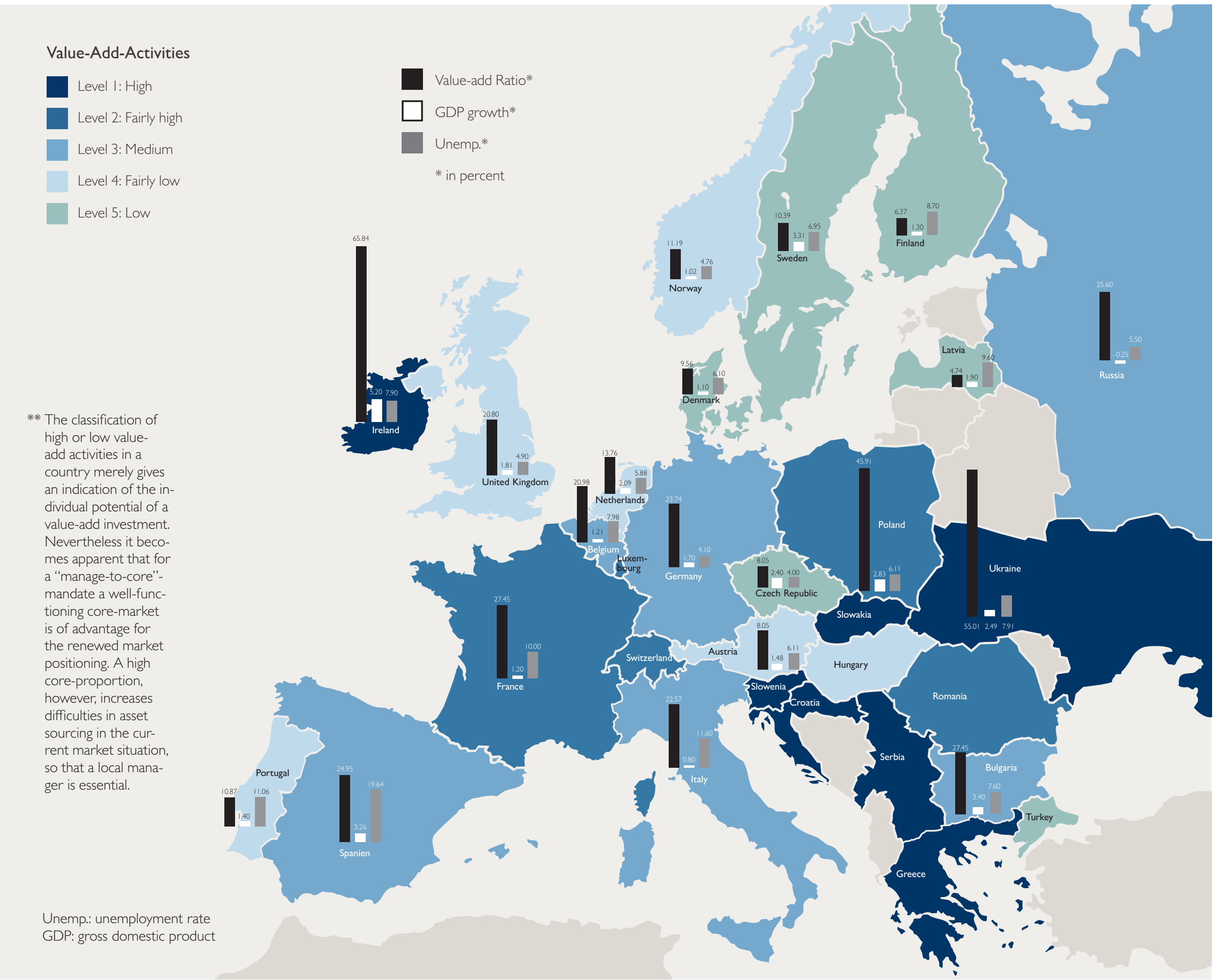
Source: Catella Research 2017, Real Capital Analytics (RCA)

The different magnitudes reflect the liquidity structure of the respective investment destinations and the current investor focus. It gets more interesting when the value-add and asset management potential are examined in a comparison of different investment styles.

The figures for 2016 indicate that almost one in four property transactions is connected with the topics of renovation and restructuring. Whereas in Central and Western European countries and some Nordic countries one in five transactions has an operational value-add component, in South-Eastern European countries, this applies to almost a third of the units changing hands.

Catella Research has designed a **value-add ratio** – the ratio of the value-add volume to the core volume – in order to derive the share of the value-add volume in the individual countries. Ignoring the two statistical outliers – Greece and Croatia – the average ratio is around one-quarter. The higher this ratio is, the higher the value-add activity in a country. The figure for the German market of 0.24 roughly corresponds to the median of the statistical analysis. The reciprocal value of just over 4.21 is to be interpreted as meaning that almost one in four of the properties changing hands is attributable to the value-add segment.

FIG. 7: MARKET ACTIVITIES ** OF VALUE-ADD INVESTMENTS IN EUROPE (2016)

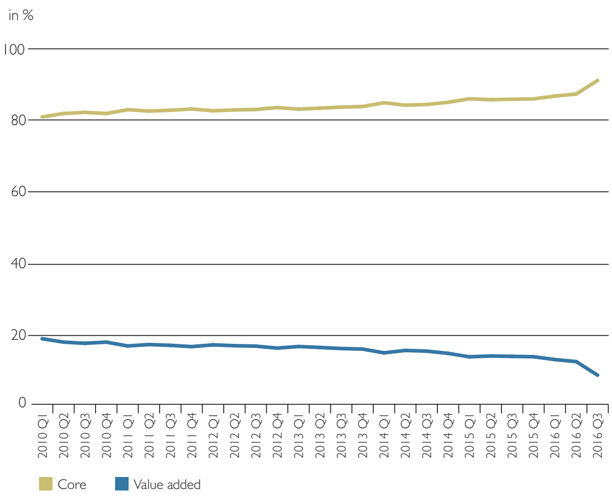


Source: Catella Research 2017, International Monetary Funds (IMF), Real Capital Analytics (RCA)

Notable negative or positive relationships between the value-add ratio and macroeconomic variables such as GDP growth or the unemployment rate are not statistically significant on the basis of 95% confidence intervals. However, it can still be assumed that there is a clear positive linear relationship between the unemployment rate and the level of value-add potential in a country. By contrast, the linear relationship between GDP growth and the value-add ratio can be classified as slightly negative.

Our analysis based on the RCA figures is reflected relatively well in the INREV data. Looking at the period between the first quarter of 2010 and the third quarter of 2016, an average of 84% of all funds claim to pursue a core strategy, while 16% state that their funds are based on a value-add strategy. A statistical bias can be assumed, meaning that the real figures for value-add funds are likely to exceed the INREV figures.

FIG. 8: DEVELOPMENT OF INVESTMENT STYLES (AS PERCENTAGE OF NAV)



Source: European Association for Investors in Non-Listed Real Estate Vehicles (INREV)
Presentation & design: Catella Research 2017

Strategies of real estate private equity funds

The strategies of real estate private equity funds are aimed at properties from a wide range of use types with high anticipated development and value enhancement potential. In economic terms, property markets have a specific lack of transparency in comparison to equity markets. This particularly applies to properties with value enhancement potential. This affects both asset sourcing and pricing. The asset manager must identify temporary valuation errors and raise the values by means of development and redevelopment as part of active asset management. The temporary assumption of risks entails a correspondingly high risk premium.

Design of real estate private equity funds

The preferred legal form for value-add funds in Germany is that of a limited partnership. However, the termination date of the fund (and thus of the company) is often regulated in the partnership agreement. According to Catella's estimates, the average leverage exposure for such value-add funds is 60% to 70%. We expect that this average will rise slightly in the future, that banks will increasingly accept loan-to-value ratios, and that the German Investment Code (KAGB) will not place any restrictions on the LTV in the institutional (professional) segment.

The term of the funds is usually between 6 and 12 years. In this context, it should be noted that the length of time for which the individual properties in the real estate portfolio are held is much shorter. The average holding time for a property is between three and four years. Remuneration for the management service is primarily based on ongoing remuneration and the property exit. The increase in the property's value – which must be confirmed by an annual expert appraisal in the regulated sector – is remunerated on an ongoing basis, and the manager participates in the exit if a defined threshold for the project's internal rate of return is exceeded in advance. There is thus an implicit alignment of interests between the manager and the investor, meaning that the use of co-investments – which represents the manager's investment in the project – is not necessarily required.

New fund vehicle for investors: real estate private equity funds

With regard to the generation of the total return for the investment, the dominant factor is the development in value, while the distribution yield is generally negligible as a yield driver. Catella Research estimates that the increase in value accounts for 80% of the total return, while the distribution contributes only 20%. Traditionally, the total return includes a growth component (value) and a cash component (distribution).

All value-add real estate funds that make investments in the commercial segment were included in this analysis by Catella Research. For core funds, the primary value driver is the cash component (60%), while the growth component accounts for less than 40%.

Looking at the development of the total return between 2004 and 2015, the average total return for the value-add segment of 13.4% considerably outstrips the average figure for the core segment (4.5%). Although volatility is much lower for the core segment, this is not enough to compensate for the difference in yields. The Sharpe ratio for the value-add segment of 0.91 is therefore considerably higher than the equivalent ratio for the core segment (0.23).

FIG. 9: TOTAL RETURN – CORE VS. VALUE-ADD

Source: European Association for Investors in Non-Listed Real Estate Vehicles (INREV)
Presentation & design: Catella Research 2017

It should be noted at this point that a core fund has much higher diversification at the level of the individual fund, meaning that the risk associated with a value-add fund is considerably higher. On the other hand, total returns of more than 20% at individual fund level are not exceptional. The total return is regularly postulated as the internal rate of return (IRR) for individual value-add funds, as timing is extremely important for the sale after refurbishment.

Besides the yield aspects, investing in a value-add fund brings significant diversification potential for institutional investors who already have a high exposure to direct and indirect core investments.

Summary

The current momentum in the “value-add” (VA) segment is triggering two market reactions at once: firstly, for each euro invested, asset management measures worth 20 cents are capitalised. This comes to a total of up to EUR 10 billion by 2021 in Europe. Secondly, it is giving rise to a strong focus on real estate private equity funds, which have a new target group structure. Due to the continuing compression of initial yields, institutional investors’ interest in value-add investments is growing in the current year, too. The liquidity to implement such investments is generally available. However, there are still supposed risk factors preventing the market from being flooded with VA funds: Besides the general lower transparency of B and C markets and areas in the respective investment locations, there is particularly a shortfall in terms of the number and quality of suitable players with high expertise in asset management for value-add properties. This exclusive investment niche therefore remains limited to a small number of investors. A possible restrictive expansionary measure by the European Central Bank would have less of a negative impact on value-add funds than on core funds, as the higher return on assets produces a positive leverage effect.

We essentially expect that interest among institutional investors will also lead to actual willingness to invest. An analysis of the target yields of value-add funds generally indicates that investors will develop this willingness. In operational terms, it is also apparent that a possible exit can be considered positive for investment managers based on the current market situation. Nonetheless, documented expertise in strategic and operational asset management is essential. This ability represents the real value driver.