A supplement to *Institutional Real Estate Americas*

INSTITUTIONAL REAL ESTATE AMERICAS

Sponsor Interview

Finding Core Around the World

A roundtable discussion with Deutsche Asset & Wealth Management

Recently, ***Jonathan A. Schein,*** *senior vice president, managing director of business development at Institutional Real Estate, Inc., spoke with* ***David Edwards, Rahul Ghai, Kevin Howley*** *and* ***Clemens Schaefer*** *of Deutsche Asset & Wealth Management (Deutsche AWM) about core real estate markets around the world. The following is an excerpt of that conversation.*

How attractive is core investing in your particular region and why?

Howley: The United States is widely thought to be the largest, deepest and most transparent core real estate market in the world. Those qualities alone make it attractive, but it is also showing solid growth compared to other regions of the globe, with performance averaging more than 14 percent per year for the past five years, as measured by the NCREIF-ODCE Index of Diversified Core Funds. The market has clearly recovered the value lost in the last cycle, but there is still room for growth, potentially. As long as the economy stays on track — and it appears to be on track to become the longest expansion in history — demand should stay strong. We see somewhere around 2 percent GDP growth and 2 million new jobs this year. Core real estate occupancy is at 93 percent, and income growth continues to impress, trending toward higher single digits in many of the key markets. This is potentially attractive because rising income is a very potent hedge against the widely anticipated uptick in interest rates that people think may commence later this year.

Will this return level continue?

Howley: It is an auction environment in many cases for these core properties, so the market isn't full of the low hanging fruit that drove a lot of that 14 percent return. But the signs of equilibrium outweigh signs of excess at this point, which suggests more of a recovery phase than being at the absolutely top of the market. In addition, we think the Fed is going to move very incrementally and inflation is going to continue to stay restrained.

Following up on Kevin's U.S. overview, how attractive is it today for core investing in Europe?

Schaefer: Core investing has always been attractive for those looking to outperform fixed-income investments with relatively low risk. So, on a relative basis, core real estate still looks attractive and is capable of substantially outperforming fixed-income products. It really comes down to return targets, but our forecasts point to range projections between 5 percent and 7 percent, unlevered, depending on market risk.

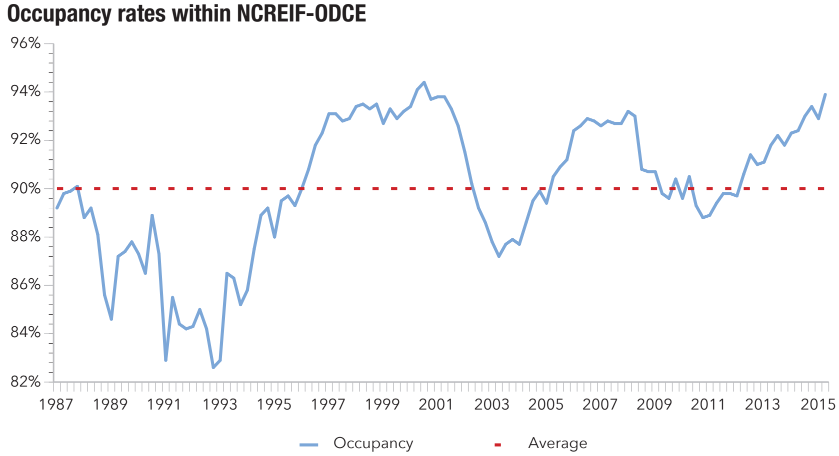
Is that a significant difference from the past few years?

Schaefer: It is a tremendous difference. In 2011 and 2012, for example, there was a lot of catching up to do. There was a lot of capital appreciation left in the real estate asset class. At that time we felt comfortable underwriting core returns in the high single digits or low double-digit returns with moderate leverage. Today, it is a much more stable contributor to your portfolio, providing fewer capital growth opportunities but reliable cash flow.

What about Asia?

Edwards: Clearly, core real estate is attractive given the increase in the volume of capital that we see looking to access core assets.

Occupancy rates within NCREIF-ODCE



Source: NCREIF-ODCE, June 2015

Ghai: Obviously, it is a very diverse region, but the key factors that are driving core invest-

David Edwards is the portfolio manager for direct real estate Asia-Pacific. He joined Deutsche AWM in 2015 with 24 years of industry experience.

Rahul Ghai is head of real estate acquisitions and asset management, Southeast Asia and Australia, and is responsible for driving acquisitions in the Asia-Pacific region. He joined Deutsche AWM in 2011 and has 11 years of industry experience.

Kevin Howley is the lead portfolio manager for direct real estate in the U.S. He joined Deutsche AWM in 2002 and has 35 years of industry experience.

Clemens Schaefer is CIO for real estate Europe and head of portfolio management for institutional clients in the region. He joined Deutsche AWM in 1998 and has 17 years of expertise in real estate investment management.

ment in this part of the world include economic growth, urbanization and a growing population. An important factor is the growth of China and its impact on trade and the logistics sector. Finally, the policy initiatives to expand trade and increased transparency in the region are all supporting the case for core investment.

Are there core assets in all the Asian markets?

Edwards: We perceive core as being in the more developed and transparent markets, primarily Japan, Australia, Korea and Singapore. There is an argument to be made that emerging markets can also deliver core assets, but if we stick to the fundamental principles of longer leases, transparency, effective legal framework and secure income flow, then it would be quite challenging to try to construct a core portfolio in other parts of the region.

What is a fair return range at this point?

Howley: We have seen a wide dispersion of returns for core for the past 10+ years. It has either been double digits up — I think eight of the last 10 years were double-digits up — and two of the last 10 were double-digits down. Given our analysis, we appear to be entering a more normal period of high single digit returns, with current income comprising the majority of the total return. That is about what you would expect in the environment we are in today, and that is another indicator of the market settling into an equilibrium phase.

Edwards: I agree with Kevin. Our view in Asia seems to be very much in the range of 4 percent to 5 percent cash return, with 8 percent to 10 percent total return (levered, after taxes and fees).

Schaefer: It's important that you have realistic return expectations in Europe, where we are experiencing a very high demand for core product. If you apply moderate leverage between 30 percent and 50 percent, we believe that, based on calculations, an investor can realize a cash-on-cash target, after taxes and fees, of 4 percent to 5 percent and an IRR target of 5 percent to 6 percent.

Historically, investors have looked for higher returns when investing internationally. Why are global core investments now more popular?

Howley: Competitive income yield and portfolio diversification have been the fundamental drivers of allocations to core real estate. In addition, after the last cycle, investors were drawn to core's much lower volatility. So there has been a structural shift to private core real estate serving as a foundational piece and garnering a higher amount of the total real estate allocation. Low-leverage core real estate is cycle tested. It can offer a more predictable performance profile because it is a blend of current income and growth. Having current income as a significant part of the total return really does set it apart from the higher-leverage, higher-return strategies that tend to be more back-ended, as well as more volatile.

Schaefer: Global core investments are becoming more popular due to several factors. First and foremost, the return premiums requested by investors for investing abroad are declining. This is mostly due to a better understanding that core is less a question of country and more of aspects like micro location, asset quality, liquidity, transparency, etc.; i.e., there are also core assets outside of home markets, and professional asset managers with strong local presences are the mitigation for investors who are not experienced abroad. Second, investors are again recognizing the benefits of diversification and want to make their portfolios less dependent on the faith of just one or two major economies. Lastly, property cycles vary between countries, and by increasing the number of potential target markets, it allows investors to extract value from differing ones.

Edwards: Globally, we are seeing a growing number of investors who appreciate that the diversification argument truly does work. That means that if you are investing cross border for diversification, it doesn't have to be for opportunistic and higher returns.

Ghai: In Asia, interest in core has been increasing as transparency has improved. The extent of transparency in markets like Australia, Singapore, Hong Kong, Japan and Korea is very good.

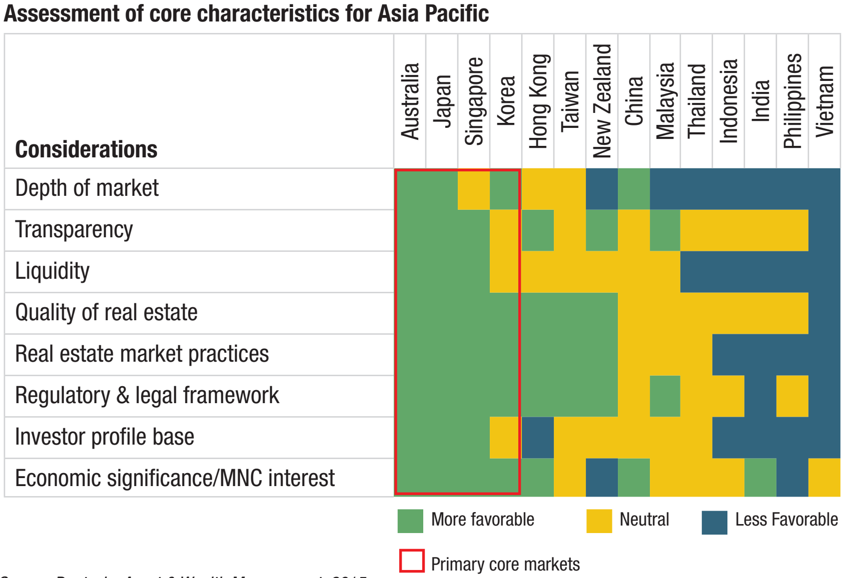
Where are the opportunities to invest here in the Americas?

Howley: Generally speaking, supply and demand are balanced across all sectors, but we like the office and industrial sectors because they are more tied to the growth sectors of the economy today. We also have an interest in "next tier" locations, which are near city centers, in or around the gateway markets. Good infrastructure, established labor pools and demand are really moving into those markets today. We also have an eye on markets that were hit harder by the housing downturn and have experienced a later recovery. Those broad themes aside, asset selection is really critical. Core real estate investment remains highly idiosyncratic. We use our knowledge of the markets and the buildings themselves to identify pockets of mispriced risk or places where potential value could be created. So even though we are focusing on the core space, this is not a market that lends itself to a passive strategy or just picking up real estate on the cheap. Not all markets are behaving equally at this equilibrium and expansion stage. They present different opportunities and different levels of risk.

What do you look for in these markets?

Howley: We look at cities in terms of the size and depth of the labor pool, and the industries that are catering to that labor pool. Technology is a big driver, as is healthcare. Meanwhile, the energy sector, which was seeing a lot of growth, has pulled back. Gateway markets remain far and away the preference of core

Assessment of core characteristics for Asia Pacific

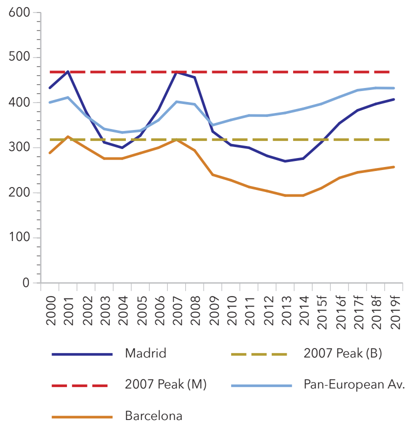


Source: Deutsche Asset & Wealth Management, 2015 investors. They are much deeper and more liquid and feature very talented labor pools. They typically have supply constraints and strong, vibrant economies that are diversified.

Edwards: Asia is very diversified. In Australia, we see good opportunity in the first-tier markets, such as Sydney and Melbourne. The office market is in good shape. The retail market is more nuanced. You need to be much more careful to consider catchments and regional demand. The warehouse market is less strong in Australia but is well supported from an investment perspective, if the right opportunity arises. If you move north to Singapore, we are more cautious on the office sector. We like the suburban retail story, but it has to be right the asset, and those don't come up very often. We like the industrial space and see opportunity in the markets. In Korea, the office market is a little soft right now. If we see weakness or any softening in prices, then we would see that as an opportunity to accumulate. Retail space is more challenging. The industrial market has not been as easy to access among international managers, but it is one that we have experience in and we like. Moving over to Japan, the prime office sector is incredibly competitive, but we do see opportunities in the not super-prime offices in Tokyo and in prime locations in secondary markets around Japan. On the industrial side, the demand and trade flows are good, and much of the warehouse stock is still old, traditional, single-story warehouses that don't work well for modern logistics, and we are focusing on the latter.

Schaefer: In Europe, we are staying away from the fully priced markets, such as Central London and the Paris CBD, where a tremendous amount of capital is hitting a limited supply. Instead, we are looking at markets that still have some growth, based on a comparison of historic peak pricing and where rents and capital values have been in the past. We saw prime rents and capital values decline 50 percent to 60 percent in Madrid, Barcelona and Lisbon, for example. Rents are just at the beginning of their recovery; almost nothing has been constructed, and older product is really falling out of fashion. So if we find a modern building, we will be aggressive when underwriting the initial yield and benefit from rental growth in the long run for the office. Warsaw is also interesting. We have supply overhanging the market and rising vacancy rates, but we believe that the 3.5 percent GDP growth Poland is expecting — and even more in the Warsaw area — is going to continue pushing the demand for office space. It's probably the

Prime Spanish Office Rents (€psm)



Source: PMA, Deutsche AWM, July 2015
Note: f = forecast

only capital in Europe where you can now buy top-quality product at sixish initial yields. We also see opportunity in the top seven cities in Germany. I would probably prefer to have the crane myself because new product is leasing up very quickly. With regard to retail, we like dominant shopping centers. We believe we can buy them almost everywhere in Europe, but demand for this product is also pretty high, so we need to analyze very carefully what the pack of investors is chasing. We are a big fan of logistics investments all over Europe. We are probably most bullish on logistics, together with the office story in Southern Europe.

Where do you see risks?

Howley: The major risk is the potential change in the cost of capital. But in a rising interest rate environment, properties with income growth potential will become very desirable. Investments exposed to flat or declining income streams, especially those that are locked in with longer lease term contracts, are going to have a hard time keeping up. They are going to behave like a fixed-income investment, where the income is fixed and the yield is going up, so the value goes down, just like any bond. The other systemic risk is that the driver in a lot of the markets where we invest is the tech sector. The tech industry has historically been extremely volatile and the potential for shakeout and disruption is a given. Having said all of that, you short the tech sector at your own peril, because it is such a strong part of what is happening with the economy today. We don't see this as a revisit of the 2000 tech bust, but we do think you want to take a balanced approach in terms of your industry and market exposure and make sure your portfolio is reasonably well balanced across the tech sector.

Ghai: We would be cautious toward Singapore office for now, as, it is very richly priced and the country has a large amount of supply coming in 2016 and 2017. We would be careful when considering Australian retail. The emergence of online shopping and change in trends has resulted in us being more careful about the kind of retail assets we invest in. Neighborhood shopping centers are our favorite because they deal with day to day items, like food, groceries, wine, cheese. Then in Korea, we are leery of office because the vacancy is quite high and rents are softening. In Japan, office in Tokyo is very richly priced, so we would avoid going there. Now, because it is all cyclical, these things will change. There are good sectors; it is just not the right time today.

Schaefer: In general, we are not a big fan of office buildings in business parks and retail parks outside of major metropolitan agglomerations. We believe that office business parks really start to benefit very late in cycles when the CBD markets are running out of availability and seeing rents rising and vacancies dropping. By that time, the cycle is getting ready to turn, supply is flooding the market, and it's hard to get your initial pricing back. So we are not big fans of office parks or peripheral retail. That's something we try to avoid for all of our core portfolios.

How do you evaluate opportunities?

Howley: Speaking on behalf of my colleagues, something that can be found across our core strategies is a similar approach to fund development. First and foremost, the key theme is really portfolio construction — weighting the property sectors, getting the market mix right. That matters a great deal in terms of risk management now. In an equilibrium environment, you want to be balanced. You want to be thoughtful about where you are going to try to derive alpha and where you are managing your downside risk if the economy slows down. The quality, durability and growth profile of the income stream is probably the key driver of performance in this phase of the cycle, and so the focus is really on distributable cash from the investment — where will it come from? We also pay a lot of attention to the basis. The investment basis in the property must be favorable to replacement cost. Finally, we want to define a viable thesis for the investment's value growth, which almost always ties back to the investment's income-expansion potential. We have a changing environment and preferences of where to live, how to work, where to work — all those things are evolving and creating opportunity, not just for noncore investment strategies, but for core investment strategies. Positioning yourself into those nodes and those locales where you think that growth is sustainable and will expand and continue is a potential strong driver of performance in the years ahead. So the core market remains dynamic and very interesting.

Ghai: There is a common overriding discipline that is applied to our core strategies but is adapted to regional conditions. For starters, we would look at the sector and the timing of the sector in the cycle; second thing is, we always keep in mind the demographics and what is going to be supported by demographics in a country. A very simple example, to put it into perspective, is neighborhood shopping centers. You have to look at the demographics in the area. Now what is happening in the retail market in the country is relevant, but not as relevant as what is happening in the neighborhood because that is what is going to drive sales in the neighborhood shopping centers. The third is the risk-return. We have to be very disciplined on what we call core and how much risk are we are taking. Fourth, we look at what is happening in the broader economy. Where will the growth come from? Where will the demand come from? So these are the four key factors that I would look at when we are doing the transaction from a big picture perspective. When we go down to the asset level, the location of the asset and the quality of the tenants is critical. There should be an opportunity to enhance the asset's income stream, while holding it in our portfolio, and keep the asset relevant in the market. Lastly, as an organization globally, we are making a big effort on sustainability. Some markets in Asia, like Australia and Singapore, are ahead of the others in enforcing sustainability initiatives, both at the local level and at the government level, but as an organization, we always have that as part of our asset management plan.

Edwards: Sustainable initiatives are one way for core assets to outperform. We see real value creation from such initiatives, rather than it simply being a talking point.

Schaefer: Research is a very important component of the investment process, whether it be for Europe, the U.S. or Asia Pacific. But specific to a particular region, we would employ a robust, in-house scoring and research process. We analyze the macro and micro markets, and the physical attributes of the building itself, and score it relative to its market. Then we have our house view forecasts, where we form an opinion among our asset managers, transaction officers, portfolio managers and research team on the future prospects for the respective markets. Based on that, we analyze the asset. If all that reveals that we believe we can get an attractive risk-adjusted return for it, then we follow up. This is a process that is pretty homogenous over the region, so that we can compare investments and determine from a risk-adjusted-return basis whether an investment in Spain might be more appealing than in Italy or in Germany. Determining the best risk-adjusted investment is what it is all about. ❖

CORPORATE OVERVIEW

Deutsche Asset & Wealth Management's real estate investment business has been investing in real estate assets for more than 40 years. As part of the Alternatives and Real Assets platform, the business has more than 450 employees located in 22 cities around the world. It manages $51.1 billion in real estate assets as of June 30, 2015, on behalf of institutional investors and private clients worldwide.

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