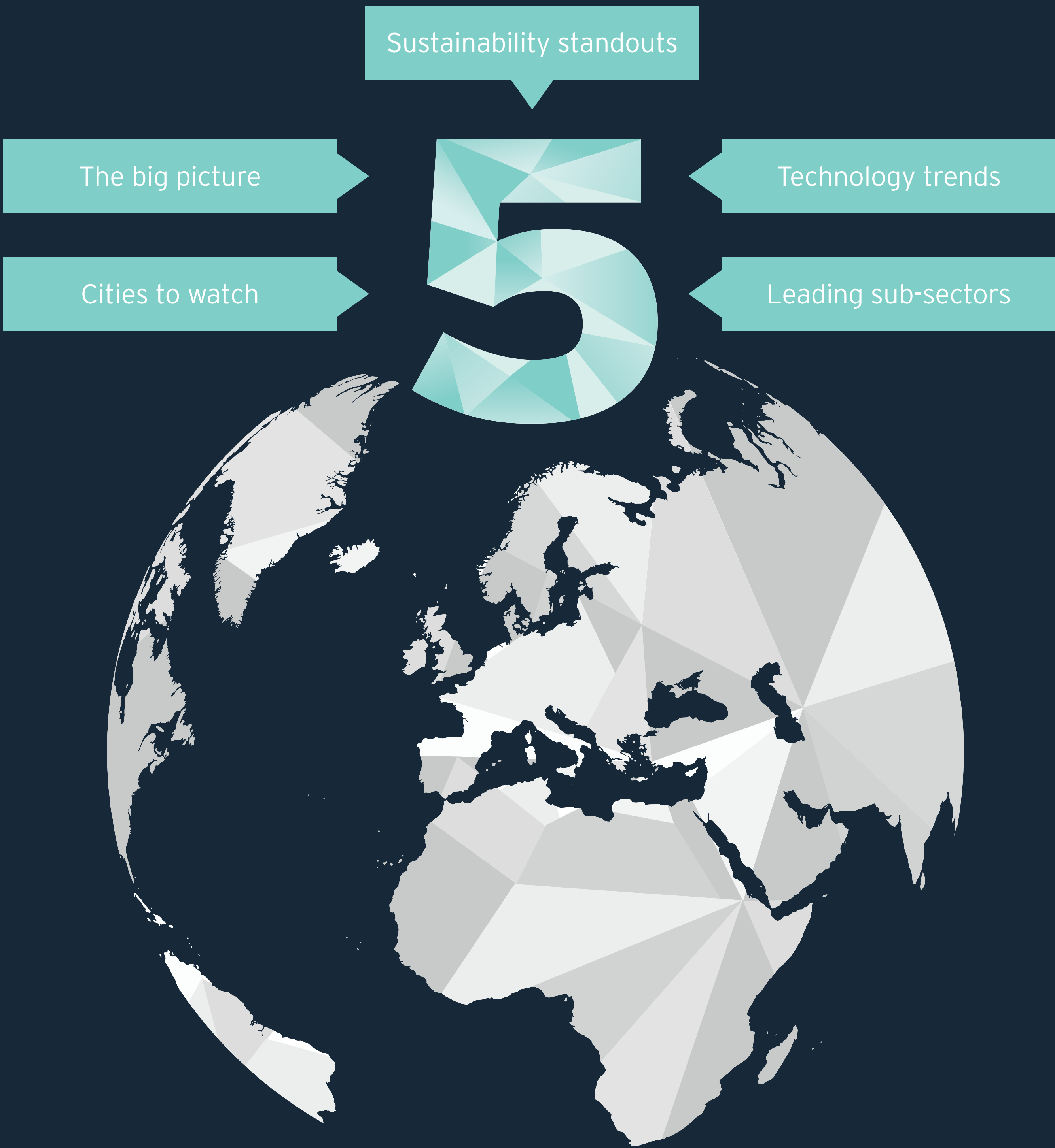
TH Real Estate

THINK 2017:
Five things you should know



1. Five big picture trends that will impact 2017

Geopolitics at the forefront of investor decision making

2016 will arguably be remembered as the year political and ideological considerations "trumped" economic logic, and markets lost faith in pollsters. 2017 looks primed for another year of political disruption, with trade, migration, and globalisation all centre stage. As the dust settles in the US, investors will need to decipher the incoming President's campaign trail rhetoric, compared to his more pragmatic victory speech, and the implications of promised fiscal expansion. In Europe, we will see Dutch, French and German elections, and April 2017 will signal the start of UK negotiations with Europe, the terms of which remain largely unknown. Bouts of renewed financial market volatility should not be surprising but it would be wrong to underestimate global growth, which has proven resilient thanks to promises of unconditional support by Central Banks, and favourable structural dynamics in emerging markets. In Asia-Pacific, the Chinese wobble early in 2016 has been largely forgotten, and economic conditions across the region are likely to improve modestly in 2017.

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The start of divergent monetary policy

We believe the US economy, close to full employment and with core price pressures building, can withstand glacial moves by the Fed, putting upward pressure on the US dollar and treasury yields. In contrast, Central Banks elsewhere will continue their promise of unconditional support, given projections for below-par growth and inflation. Through a combination of disinflationary pressures, technology, globalisation and excess savings, global long-term interest rates have followed a steady downward path since the late 1970s; and investors now seemingly acknowledge lower long-term government bond curves. Talk of the 'Japanification' of Europe (i.e. Europe following in the footsteps of Japan, which over the past decade faced a poor demographic outlook, sluggish economic growth and deflation) is justified. Despite the implied modest economic and inflation outlook, potentially dampening occupier demand, this could prove to be a tail wind for real estate pricing, given a well-documented desire for income.

Debt weight

A huge build-up of excessive private credit, and subsequently public sector debt, proved a pivotal catalyst in the Global Financial Crisis, and is also the cause of the world's subdued economic recovery. Concerns attached to excessive debt in China and Japan have the potential to erode some of the positivity regarding Asia-Pacific economic growth projections in 2017, as emerging markets adapt to an era of a stronger US dollar and commodity pricing. Despite negative interest rates in Japan, low real wage growth has not decisively strengthened consumer demand, due to structural headwinds. In Europe, the debts accumulated are so vast that they will not be eroded by muted growth and inflation, despite employment, credit lending and real incomes improving. The US financial and real estate markets were swift to move through the credit cycle, from a repair, recovery and now expansion phase.

Structural funds gain momentum

Attracted by past and projections for future performance, an attractive yield profile, access to stock and a maturing, more liquid market, a growing pool of investors are now looking with interest beyond the traditional sectors of real estate to alternative sectors. At TH Real Estate, we prefer the term 'structural funds' because of the scope, scale and opportunity that these sectors offer in relation to megatrends. The residential, student housing, hotel, healthcare, leisure and data centre markets are significant in their own right, particularly in the US and Asia-Pacific. Market forces, reflecting current investor risk aversion and a growing competition for core, prime assets, coupled with longer-term drivers of demand, will ensure a broader move into structural sectors by investors seeking to enhance returns and lessen their reliance on traditional stocks and bonds, amid challenging performance expectations.

A cities, not just currency, investment rationale

We believe the strength of the US and selective Asian currencies, combined with the weakness of both Sterling and the Euro, given economic and political instabilities, will buoy real estate capital flows into Europe. These currency swings are unlikely to reverse materially, given implied European interest curves, but neither should they be the sole reason for expanding overseas exposure. A city-based real estate strategy, under-pinned by long-term structural trends that strike the right balance of risk and diversification, while taking advantage of currency and short-term pricing opportunities, should enjoy above-average portfolio-level returns, below-average volatility, and modest downside risk, for long-term investors.

> 2017 will signal the start of divergent, global Central Bank policy, with pronounced implications for equity, bond, and real estate markets.

Michael Keogh
Associate Director of Research & Strategy

2. The five cities to watch in 2017

Hong Kong: the year of political polarisation

Since Occupy Central in 2014, political discourse in Hong Kong has continued to worsen, particularly among the youth population. Sky-high property prices, lack of employment mobility, a widening wealth divide, and uncertainty over the rule of law heading towards 2047 (the end of the 50 years of "one country, two systems" constitutional principle), have elevated social and political tensions. According to a survey by independent think tank Civic Exchange, around 42% of Hong Kong residents want to leave the city, with 70% of the 1,500 surveyed saying that Hong Kong has become "worse" or "much worse" to live in. Most recently, the High Court has disbarred two pro-independence legislators from taking office – due to controversies over oath taking – further raising concerns over Hong Kong's judicial independence. Societal polarisation is unlikely to ease anytime soon, particularly against the backdrop of 2017's Chief Executive Election. Watch this space.

Washington DC: back to the future?

2017 may be a pivotal year for the Washington DC real estate market, which has suffered through five years of federal government downsizing and spending cuts. Previously, it had been a perennial outperformer, driven by steadily increasing government spending and an affluent, highly-educated population, which bolstered economic growth and real estate demand during national recessions. New administrations have typically provided an economic and real estate market boost, due to an influx of lobbyists, Political Action Committees (PACs), and the like. The new administration should be no different, particularly since policies and priorities are markedly different from those of the outgoing administration. With federal government wages and spending accounting for close to 40% of local economic activity, 2017 may establish the foundation for a healthy recovery of the market in the post-election years.

San Francisco: frothy but sustainable

The San Francisco economy and real estate market head into 2017 as hiring and spending by local technology companies moderate from the breakneck pace of prior years. Similarly, national venture capital funding has slowed due to stretched valuations. However, the local economy and tech sector can withstand a period of flux, given the sizeable presence of the nation's top tech companies. While office deliveries in 2017 have significant pre-leasing, vacancies are likely to rise modestly due to sub-lease space and areas being vacated by relocating tenants. Similarly, apartment vacancies will tick higher as 2017 deliveries face weaker demand. With San Francisco having some of the highest office and apartment rents in the country, tenant interest and activity in more affordable areas of the neighbouring Oakland metro area have increased, and could provide an effective arbitrage play.

London: the cycle is back!

So why London at a time when the UK faces major disruption from the Brexit process? Because we believe 2017 will be the year in which uncertainty in leasing and capital markets will provide investors with an opportunity to access enhanced office returns. Apart from its greater volatility, London has an attractive risk profile: a highly-transparent market with deeply-liquid capital markets and solid income security. So it's hardly surprising it has long been the world's largest cross-border investment market. Surveys have almost consistently shown London to be the number one choice for the location of financial firms. Even amid Brexit uncertainty, its critical mass will ensure it stays dominant and streets ahead of any other European contender. However, London is not just about financial strength; it hosts the highest concentration of business start-ups in Europe, and significantly appeals to entrepreneurs seeking to network and develop new ideas.

Berlin: the new hipster favourite

Berlin has long been a favourite of millennials and creatives, but until recently, the economic heartbeat of the city was dominated by government activity. More recently, Berlin has emerged as the place for technology companies as well as a favourite of consultancies. The associated shift in occupier demand has underpinned the real estate investment cycle. In 2016, Berlin was among the top cities in Europe for rental growth with a record-low vacancy rate. Finding large vacant prime space in central Berlin is a challenge for occupiers, with the Berlin economy developing strongly. Berlin has long been a hidden champion and not "corporate" enough to attract companies. Today, there is a resurgence of the city and this time it seems more sustainable than the post-reunification boom of the German capital.

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Andy Schofield
Director of Research

3. Five sub-sectors to keep an eye on

Commercial Real Estate Debt (CRE Debt)

In our opinion, elements within the European real estate market look late cycle. Investor activity has been buoyed by the prolonged low-yield capital market environment, but clear risks exist given heightened geopolitical uncertainties. Against this backdrop, CRE Debt in 2017 can provide an opportunity to lock in stable, income-focused returns, insulated from volatility that may occur in the wider property and investment market. Appealing to diversified investors, CRE Debt can offer a spectrum of returns via different styles and sizes, held within a variety of security packages, tenors and structural features, across a range of markets, sectors, investment grades and pricing cycles. Given structural changes in the European lending market since the Global Financial Crisis, 2017 looks poised to cement alternative lenders as meaningful providers of CRE Debt investments.

Mixed-use

Mixed-use, by definition, isn't really a "sector" and many investors have been wary of mixed-use projects on the basis it is not obvious how they should be managed. As such, a discount can be achieved with the total value of an asset being less than the sum of the parts. However, increasingly, office occupiers are attracted by the presence of retail or experience, while shopping centres will benefit from proximity to office populations and a higher leisure content. Millennials expect to be able to shop, work and socialise when they like, and not necessarily make unique journeys for each. In order to attract young talent, office occupiers' location strategies are increasingly focused on where that talent wants to live, and so we see office and residential quarters encroaching on each other, with the common ground being leisure or retail. Buildings or estates that successfully combine a number of different use types are likely to enjoy higher footfall, longer dwell times, and ultimately become more productive. Over the medium term, it seems likely that mixed-use is a sector that will command a premium, rather than offer a discount.

Data storage: it's about the location

The world is becoming more information centric. Societal reliance on creating and consuming data continues to grow, as well as the need for data to be available when and where it is needed. Indeed, data growth rates necessary to sustain business activity, enhance IT service delivery, and enable new applications, will continue to place continued demands that require more processing, network, bandwidth and data storage capacity. Nowadays, organisations of all sizes are faced with having to do more with less, including maximising IT resources against footprint constraints. Beyond simply finding space to store data, organisations need to keep digital information safe, private and secure, in order to protect intellectual property rights. In this regard, only four Asian countries are considered truly secure for data storage: Singapore, Hong Kong, Taiwan and South Korea (according to data hosting provider, Artmotion). Unsurprisingly, Singapore ranked second globally, in view of its political landscape, geographic location and physical infrastructure.

Outlets: luxury on a shoestring

It's cool to love a bargain these days. Shoppers' perceptions and behaviour have changed and outlets have become trendy, with the retail sector evolving from factory outlets selling surplus stock to designer outlets with high-end concepts. The sector is in a strong state, with rising rents, low vacancy rates and buoyant occupier demand. While many retailers are downsizing their full-price store portfolio, they are still opening outlet stores, welcoming an entirely new set of customers. The shift to luxury brands, anchor stores, pop-up shops and events, to attract local consumers as well as tourists, helps to deliver the all-important shopping experience. Outlets' value offer has proven resilient to economic fluctuations and the onslaught of the internet. In the bad times, people value discounts and in the good times, luxury thrives.

Co-working

Co-working is one of the most interesting and dynamic office niche markets at the moment, and we believe in the fundamentals driving the sector, such as the changing structure of work, better technology solutions and globalisation. The share of work done digitally has increased further, and many traditionally manual jobs have been digitalised, also with better technology options. Remote working has become more practical than it has ever been, and global teams are operating across continents, sometimes without a physical office presence. Globalisation has led to large-scale outsourcing into lower-cost countries and cities, creating opportunities for entrepreneurs globally. Co-working spaces are in the beginning stages of establishing themselves as an investable niche sector, and opportunistic investors are currently focused heavily on developing their own portfolios. We think that institutional investors will buy more and more into the sub-sector as business models mature and portfolios of co-working spaces will be traded.

4. 2017 technology trailblazers

Retail and warehouse integration evolves further

Technology's impact on the retail sector, and the secondary effects on the warehouse market, will lead to a further blurring of the two sectors. Shopping apps and expectations of same-day delivery have required re-designs of retailers' distribution networks and use of stores for e-commerce fulfilment. Similarly, Amazon's relentless growth has fuelled the need for a national network of warehouses and spurred similar expansions by leading retailers, e-tailers and third-party logistics (3PLs). Retailers pay top dollar for space in highly-productive malls and shopping centres, while "last mile" locations garner eye-popping rents due to accessibility to metropolitan market populations. E-commerce is presumed to have a negative impact on the retail sector, but physical stores are still the primary point of retail sales as two-thirds of online sales involve a pre- or post-transaction store visit. Similarly, e-commerce generates 20% incremental demand for warehouse space nationally. Strategies that best utilise retail and warehouse synergies will be needed.

Open source data in Amsterdam

Amsterdam is on the road to being a truly "smart" city, in large part thanks to its open source data initiative, which aims to make real-time data on everything, from transport to energy use, to museum collections, available to everyone. This encourages and incubates local innovation which can often lead to the creation of useful products and services for citizens (be them apps, maps, or other insights). In some cases, such as air quality, the data itself is crowdsourced from the citizens themselves. With disruptive technologies increasingly leading towards disaggregation at the start and the end of every process, Amsterdam's approach has become a model on how to codify this, by bringing disparate information together, combining it into something useful (be it by the government or third parties) and redistributing it back to the community successfully. The benefits of this approach are widespread: open-source-based applications can increase the efficiency of public services such as transport; citizens and local businesses are empowered to take (better) data-driven decisions; and transparency is embedded in every process, as data is allowed to flow everywhere. All of these will help power Amsterdam forwards with stronger growth, resilient sustainability and more innovation. With people and businesses benefiting, demand for real estate is set to grow across sectors.

Driverless cars

Despite good road connectivity, there are four factors that have held cars back from their full potential: congestion, cost, parking and restrictions on who can drive. By addressing all four of these factors, driverless cars will serve to further democratise access to personal transport and will redefine personal mobility as we know it. The transition from manual to autonomous driving, is likely to start within a decade, a process which will have significant knock-on effects at city, zip code and asset level. Cities are expected to become more suburban and polycentric; areas that have good road access but no train stations, for example, might benefit. Assets will have to adapt to the new paradigm, for instance, by changing expansive car parks into compact drop-off zones. The precise implications for the urban landscape and how it is managed are far from certain, but will certainly be substantial.

The name is WeChat

Few living outside of Asia could really understand how the daily lives of 820 million Chinese people have centred on WeChat, a cross-platform instant messaging app developed in China. With its app-within-an-app mode, WeChat addresses users' needs in every aspect of life, from hailing taxis, ordering food deliveries, buying theatre tickets, to booking hospital appointments, paying utility bills…all achievable without ever leaving the confines of the app's universe. While a cashless economy is still the "next big thing" in the West, the Chinese community are living it right now. Already, Alibaba reported that this year's Singles Day raked in $17.8bn, an increase of 32% from last year. Having recently realised its ambitious move to enter the African market, it will be interesting to see how WeChat can help lift the entire African continent straight into the mobile internet, skipping the personal computer altogether.

PropTech

As the attractiveness of land is affected by a wide range of factors, from hard (like transport) to soft (like cultural norms), the impact of technology in property will be felt indirectly from many sources. However, some disruptors are now taking aim at real estate as an industry in its own right. The impact of PropTech innovations may not have as significant an impact at the property level, but they will certainly reshape large segments of an industry that, until now, has not witnessed the large scale disruption that most other major sectors of the economy have had to learn to live with. An obvious target is intermediaries, who address the information asymmetry between landlords and tenants – an asymmetry which does not seem impossible to address through tech. Agents are already feeling the pain in both residential (e.g. OpenRent) and commercial (e.g. Realla) spheres. Real estate is naturally opaque, so human experience and discretion has, until now, been relatively well-insulated – exactly how opaque it is, however, is about to be tested.

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Alice Breheny
Global Head of Research

5. Sustainability standouts for 2017

Long-term science-based carbon reduction targets

Over a year after the Paris Climate Accord, businesses have been reflecting on what the impact of the global commitment to limit climate change to 2 degrees will be on their business strategy. There have been some early adopters who have already set long-term science-based targets. We can expect many more to do so in 2017. This is a particular trend in the investment community, meaning that funds will need to build energy efficiency into their strategies if they intend to attract and keep investment from these organisations. Alongside this will be an increasing expectation from investors for sustainability data reporting and transparency. This goes far beyond carbon data to encompass a wide range of environmental and social data.

Sustainable real estate investment products

As investor preference for carbon efficiency continues to emerge, products that have an explicit sustainability strategy will become more widespread. These will encompass investments in stock that already outperforms the market, and also investment into assets with the intention of improving their sustainability and value. This comes alongside an emerging strong demand for green bonds, with similar criteria.

Health, well-being and productivity

This will continue to be a significant trend to watch as more landlords and tenants explore how they can benchmark and improve health and well-being factors such as natural light, air quality and active design. There is not currently a recognised methodology for benchmarking health and well-being in existing space. We expect that various methodologies will begin to emerge over the next year, and more information will emerge demonstrating the link between health and well-being in buildings and productivity. Tenants will increasingly take account of health and well-being factors when seeking new space.

Uncertainty about the impact of global political changes on environmental legislation

Significant political events, such as the vote for Brexit and the election of Donald Trump, create a less certain environmental legislative environment across the globe. There are immediate local impacts in the UK and US as the legislative landscape will go through change over the next few years. However, the impact of these events on global trade, investor confidence and the fiscal approach in multiple countries, will also have implications for real estate and for the role of sustainability in real estate strategy.

Growing global unrest about the status quo

As the global political situation continues to be unpredictable, it is clear that there is growing dissatisfaction with the status quo. The perception of a negative impact of globalisation, and on some traditional working communities, is becoming starker and this is likely to mean that issues, such as the living wage and unsustainable housing costs, will come into sharper focus for governments and businesses, which will increasingly seek to develop strategies to address these issues in their workforces and supply chains.

> Monitoring these sustainability trends in 2017 and beyond is crucial to help us anticipate and respond to changes in the investment market, to mitigate risk, and to protect and create long-term value. We also anticipate impacts on occupier demand, legislative and fiscal regimes, client expectations and energy supply.

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