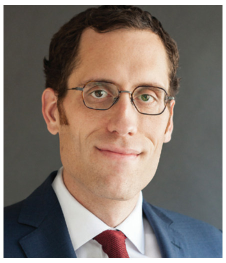

INTRODUCING THE "LIVING" SECTORS –
NEW INVESTMENT TARGETS FOR STABILITY & GROWTH IN EUROPE

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In Europe, we see a broad opportunity to invest in what we call "living" property. Simply put, this is the real estate where people make their homes at the various stages of life. "Living" encompasses the multifamily residential (rented and for-sale), student housing, and senior housing property types. It also includes specialised sub-types such as micro-flats.

These sectors add an attractive combination of stability and growth to the investment portfolio. They have a foundation of partly non-cyclical demand drivers, providing insulation from cyclical volatility. Positive structural and secular growth drivers, detailed below, should support continued growth. Finally, the "living" sectors are less established and less institutional in Europe than other parts of the property market, but they are coming into favour, signalling an opportunity to benefit from their emergence.

STABILITY

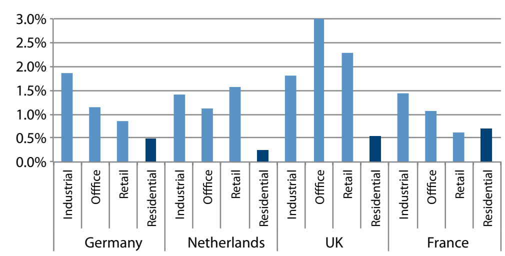
We expect European "living" sectors to exhibit remarkably stable performance, making them attractive in an environment of financial market volatility as well as slow (and possibly slowing) global economic growth. Although these property types would certainly benefit from faster GDP growth, they do not rely on it. On the contrary, they are sustained by structural and secular changes that would continue even in a recessionary environment.

Although data on the investment performance of "living" sectors remains relatively limited, a look at IPD rental growth data allows us to compare the track record of occupational fundamentals for residential versus other property types. We calculate downside volatility, rather than overall standard deviation, so as to not penalise sectors for upside surprises. Downside volatility is defined as the standard deviation of any results that fail to meet some baseline hurdle return. For this hurdle we used the actual rate of inflation in a period. In other words, we measure *the risk that each sector will deliver worse than 0% real growth.*

As Figure 1 shows, downside volatility in the residential sector is less than that of the commercial sectors in all countries other than France, where it is the second lowest. This suggests that risk-adjusted returns in core residential strategies can be attractive even where the absolute rate of return may be low.

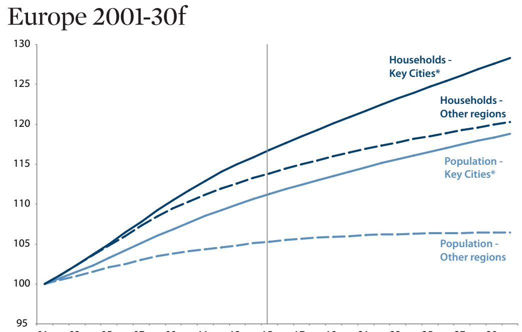
The performance of student housing in the UK, another sector for which we have some data, also exhibits stability. According to a database of assets compiled by CBRE, student housing returns have been steady in a narrow range of 9.8%-10.9% per year over the 2011-2015 period for which we have data. This compares to IPD returns for the commercial sectors that have ranged from a low of 2.4% for retail in 2012 to 23.3% for industrial in 2014.

Figure 1 Downside Volatility* of Rents 2000-14



*Downside volatility is defined as the standard deviation of negative real rental growth results (rental grows minus inflation). Downside volatility is a component of the Sortino Ratio concept, which is concerned with downside volatility, ignoring upside surprises. Source: IPD; Heitman Research

Figure 2 Population and Households Western Europe 2001-30f



*Key cities refers to 41 significant metro areas across Western Europe. Source: Oxford Economics; Heitman Research

Why such stable performance? We think it is due to three factors: "living" sectors' non-cyclical demand drivers, the volatility-dampening effect of regulatory systems, and the unique characteristics of residential tenant credit.

Non-cyclical drivers

Unlike the fundamental factors behind incremental absorption in the commercial property sectors, which revolve around business investment, "living" sectors are driven by structural/secular change, demographics, and basic needs. For example, the decision to move an elderly person into senior housing has more to do with an event, such as a slip or fall at home, than with how the economy is doing. Meanwhile, the elderly population is growing steadily across Europe. Similarly, student housing demand is driven by demographic growth of the student cohort, increased student mobility (both domestically and internationally), and the secular expansion of higher education. Policy changes are also important. For example, the UK government is in the process of lifting its long-term cap on student enrolment. It is estimated that this could result in an increase in the size of the UK's university population by up to 180,000 (about 10%) over the next three years.

Volatility-dampening regulation

Some European residential markets are subject to rental regulation, which typically has the effect of smoothing out volatility. Most notably, the German, French, and Dutch multifamily residential markets provide security of tenure to some or all sitting tenants, with increases in rents linked to an index. By their nature, such systems introduce time lags into how rental growth filters down to in-place tenants. This makes tenants stickier, as moving flats would result in a worse "deal" for them. Moreover, as in-place rents usually lag in comparison to market rents, the natural roll-to-market can support some NOI growth even if market rents are stagnant.

Residential tenant credit

Compared to commercial property, tenant credit in the "living" sectors is quite granular. With hundreds or even thousands of individual tenants in a portfolio, there is minimal exposure to any individual occupant. Moreover, default risk tends to be low, given that tenants usually "defend" their home even if they struggle to pay other bills. This is especially the case in Europe, where tenants often invest significant sums into their rented apartments by installing their own kitchens and other fixtures.

GROWTH

Beyond the stability and relative non-cyclicality of "living"-related sectors, we see a growth story that should lead to outsized investment returns. To generalise, we expect growth in investment liquidity, rents, and valuations, as well as portfolio- or asset-specific opportunities, to grow NOI. Drivers include demographic growth in the face of supply constraints, a mismatch of the existing stock to demand, and increasing institutionalisation.

Attractive urban demographics

Contrary to received wisdom, there is a positive demographic story to be found in Europe. To find it requires a look below the top-line national data to focus on individual metropolitan regions. Simply put, Europe is witnessing strong population growth in key cities, supported by international and domestic migration. The population of European cities that are closely linked into global flows of capital, ideas, and trade is booming, even while in other regions the population is levelling off and even declining, as data from Oxford Economics demonstrates in Figure 2.

The chart also shows that the rate of household growth is substantially outpacing population growth. This is due to a combination of the ageing of the population as well as social trends (e.g., later marriage) that are reducing the size of the typical household. While this pattern is consistent with a greying, less fertile society, it is also a strong positive for demand in the "living" sectors. Because the typical area required for a single-person household is almost always greater than the per person space required for a multi-person household, the trend toward smaller households drives a net increase in demand for residential space.

Fundamental supply constraints

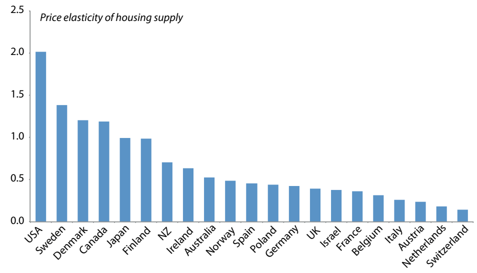
The solid occupier demand side for residential real estate is coupled with an anaemic supply side, further supporting growth in prices and rents. Generally speaking, barriers to supply in Europe are higher than in many global markets, owing to planning constraints and the scarcity of land. While it is difficult to quantify this, we use house price supply elasticity figures from the OECD as a proxy. They measure the responsiveness of construction to increases in residential prices; the higher the number, the greater the pickup in construction. As Figure 3 shows, most European markets are substantially more supply constrained than those in North America on this measure. This suggests that the supply response to increasing demographic demand is likely to be muted compared to the rise in demand. This is consistent with what we see on the ground.

Housing stock mismatch

The undersupply of "living" property in Europe goes beyond the low responsiveness of new supply. Fundamentally, the existing stock is not well matched to the needs of the changing occupier base, creating undersupply in pockets of the market. For example, many apartments in Germany are very spacious, many having three or more bedrooms. Large flats are not a good fit for the smaller households – seniors and young singletons – which dominate demographic growth. Although students or other young people may be willing to rent a big flat and share it among a group of peers, most would prefer their own space and lease contract. And many landlords, imagining the worst, are likewise reluctant to lease a large flat to a group of students.

The physical layout and fittings of the housing units are also often outmoded. Many apartments are accessible only by climbing several flights of stairs and lack accessible bathrooms. They may have level changes between rooms that present challenges to older people. Young professionals and students prefer to have their own en-suite baths, not to share one down the hall with unrelated sharers.

Figure 3 Responsiveness of Real Estate Supply OECD Economies 1980-2005



Source: OECD; Heitman Research

Quality may also be an issue. In Germany, many lower-quality 1960s and 70s plattenbau (panel block) apartment buildings are nearing the end of their usable lives, creating a shortage of stock even in cities where the demographics are lacklustre. It is estimated that it is uneconomical to refurbish around 20% of the German stock built between 1950 and 1980, or around 2.8 million units. Similarly, much of the existing senior housing inventory in the UK is dreary and tired, reflecting customer expectations from an era when residential care was government paid. Today, there are many more private-payers, and customers expect something more salubrious.

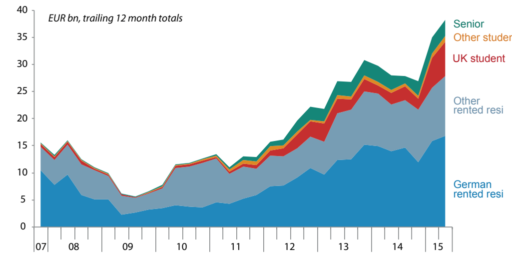
All of these factors contribute to pressure in certain market segments and geographies. Even where a market is supplied with the right amount of housing stock, it may be the wrong kind of housing. We see particularly compelling opportunities to supply student and senior housing, micro-flats for young professionals in expensive first-tier cities, rental flats designed with smaller (and older) households in mind, and for-sale apartments in desirable "quality of life" cities with housing shortages.

Increasing institutional acceptance

Another key driver of the positive outlook for European "living" sectors is their increasing liquidity and investor acceptance. As Figure 4 shows, annual transaction volumes in these sectors have increased from less than €6 billion in 2009 to more than €38 billion for the twelve months ending Q2 2015. Senior and student housing have gone from accounting for around just €500 million in activity per year to more than €10 billion.

As investors come to embrace "living" sectors, yield spreads versus other types of property – particularly for student and senior housing, where they are still wide – will continue to compress, generating an outsized capital return. The depth and range of exit options will grow, increasing flexibility. And these sectors will attract "permanent" allocations from long-term capital, as they have in the US. We estimate that the total investable universe in European "living" sectors is at least $380 billion, representing around 20% of Europe's total investable real estate market. Given their compelling characteristics, we think a portfolio allocation of at least that much is warranted.

Figure 4 European Living Sectors Transaction Volumes 2007-2015



Source: Real Capital Analytics; Heitman Research

From cottage industry to professional management

Despite the recent growth of the "living" sectors, in Europe they remain at a relatively immature stage. Until recently, all of the sectors were essentially cottage industries – developing in geographical silos without pan-European standards or knowledge-sharing. This is changing, although operational expertise remains uneven and there are still many assets that have been undermanaged. For example, in most German residential portfolios there remain significant opportunities to improve operating efficiency, reduce delinquencies, enhance expense recovery, and boost collection rates. To the extent relevant, investors would be wise to import knowledge, systems, and experience from other parts of the world, especially North America, where "living" sectors are more established and have a longer track record.

The lower degree of professionalisation in European "living" sectors implies that there are opportunities to pursue value-added strategies that address the issues with undermanaged assets. It also suggests that investments can outperform if they are managed by the right team, whether internally as employees of the investment manager, as an equity JV operational partner, or as an incentivised asset manager.

THE OPPORTUNITY

What is the best way to gain exposure to the "living" property sectors? We recommend a range of strategies appropriate for different levels of risk tolerance and cost of capital. At the core end, the risk-adjusted return of residential is compelling given the low downside volatility. Considering a still fragmented ownership base, we recommend a multi-year aggregation play. In the value-added space, there are numerous opportunities to enhance operations and add value through refurbishments, which can allow rent increases in both the regulated and unregulated markets. In some countries, investors may also have the ability to realise value gains through "liberalising" units from regulation or "privatising" (condo-converting) them. Finally, in sectors where there is an absolute shortage of space, such as student housing, senior housing, and micro-flats, development strategies may be appropriate.

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