Insights

Real Estate

SwissLife
Asset Managers

March 2016

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Editorial

Dear readers,

It gives me great pleasure to present you with our new real estate publication "Real Estate Insights", which will be published twice a year and provides detailed market research, contemporary studies, trends and commentary on the real estate sector in Switzerland, France and Germany.

The guiding theme of our first edition is "all eyes on real estate". The European real estate market is seen as an attractive asset class and it is generating a lot of interest from investors. Long-term interest rates are also increasing the appeal of the real estate market here. You can find out more on the following pages.

The investment potential in the health and hotel sectors has been widely known for some time. They form a major component of a broadly diversified real estate portfolio. Other subjects covered in this edition include the challenges and opportunities of investing in nursing homes and health centres in Germany, plus the potential of the French hotel market.

I wish you a most interesting read.

Stefan Mächler
Group Chief Investment Officer

Real Estate in an Environment of Divergent Monetary Policy

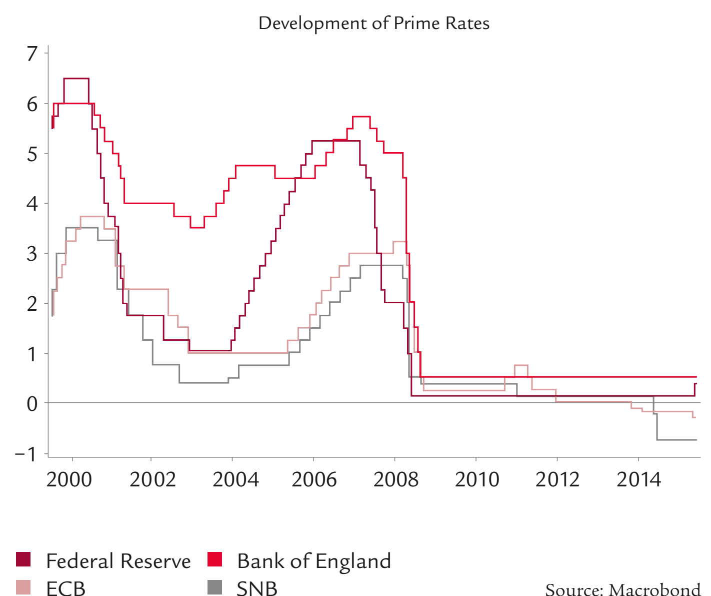
Real estate markets will remain well supported, the low-interest phase is in full swing, but how will long-term interest rates develop?

Sylvia Walter, Senior Economist, Swiss Life Asset Managers

Investing in real estate is getting more and more attractive

A first step has been taken. In December 2015, the US Federal Reserve increased the key interest rate for the first time since 2004. That said, given the latest turmoil in financial markets, they may well switch to a wait-and-see mode yet again. Both the European Central Bank and the Swiss National Bank will keep their key interest rates at a record low or lower them even further. Despite sustained strong economic momentum, the Bank of England is reluctant to hike its key interest rate "already". The Brexit referendum this year is leading the central bankers to adopt a cautious attitude. The much-quoted low-interest phase is still in full swing and volatilities in financial markets are extreme. The appeal of investments in real estate remains overwhelming.

Key interest rates in major economic regions



Source: Macrobond

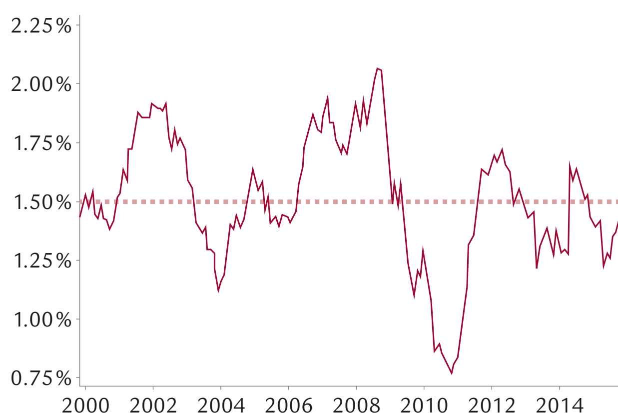
How will long-term interest rates develop in an environment of divergent monetary policy? One important factor affecting interest rates – the headline inflation rate – has been displaying a significant downward trend all around the world since mid-2014. The inflation rate is heavily impacted by the decline in raw material prices. Oil prices do not seem to be reaching a floor.

The fight for market share between oil producers is in full swing. On the contrary, concerns about China – the main consumer of raw materials – have led to additional price corrections. In the UK, France and Germany, the average inflation rate in 2015 was close to zero. Owing to the appreciation of the Swiss Franc, the Swiss economy is experiencing significant deflation. Inflation rates will remain considerably below the target values of the relevant central banks in 2016, too. There would have to be a significant rise in the oil price to belie this statement.

Core inflation has risen unperceived

Nonetheless, when it comes to pricing pressure it is important to draw attention to one aspect here: market participants are ignoring the fact that, despite all the adverse factors, core inflation in the developed world has risen to the long-term average. Thanks to the continuing economic recovery, there are certainly some areas with bottlenecks, which are resulting not least in higher wage agreements. This particularly applies to the US, UK and Germany.

Core inflation



■ Core inflation, aggregate of 16 industrialised countries, annual rate of change
⁚⁚ Long-term average

Source: Macrobond

In the industrialised nations, particularly the USA, we expect to see a moderate rise in long-term interest rates this year once recession fears have faded. In the developed countries, GDP growth rates will achieve similar levels as in 2015. Household income remains very robust taking (low) inflation into account. In this respect, the real estate markets will remain well supported. The hunt for higher yields makes investments in government bonds appear in an unattractive light. Towards the end of 2015, around 58 % of Germany's outstanding debt had a negative yield. In France the proportion was just under 52%, while in Switzerland it was as high as 68%.

> **The hunt for higher yields makes investments in government bonds appear relatively unattractive. More than a third of the debt issued by European governments had a negative yield by the end of 2015.**

European Real Estate – General Overview

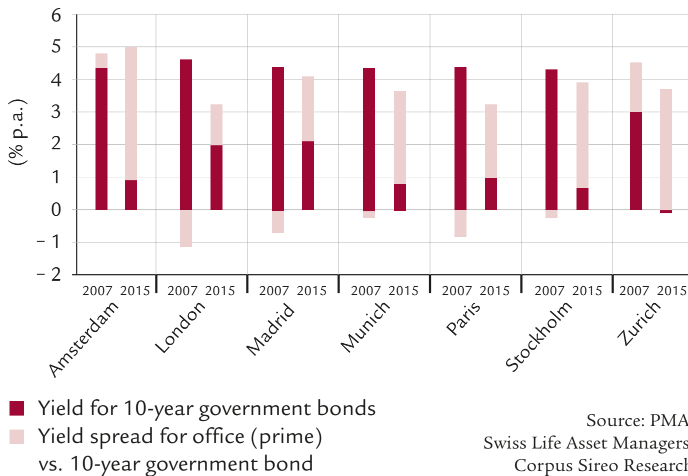
Real estate investments were in vogue again in Europe in 2015 as rising transaction volumes illustrated. An upswing on the rental markets is supporting the market and offers good prospects for 2016.

Dr. Andri Eglitis, Head of Research, Corpus Sireo

Real estate is investors' favourite

The investment volume in both the commercial and the residential sector continued to increase in 2015 – in the commercial sector alone, the volume for Europe as a whole rose to around € 265 billion, representing a 15 % increase compared to 2014. The UK, Germany and France saw the highest volumes, but the markets on the periphery of Europe became increasingly popular with investors, particularly in the case of Spain and Norway. The office sector dominates the European markets. However, retail investments posted significantly higher growth, with logistics, hotel and health-care properties becoming more established institutionally.

Yield difference between prime office properties and government bonds



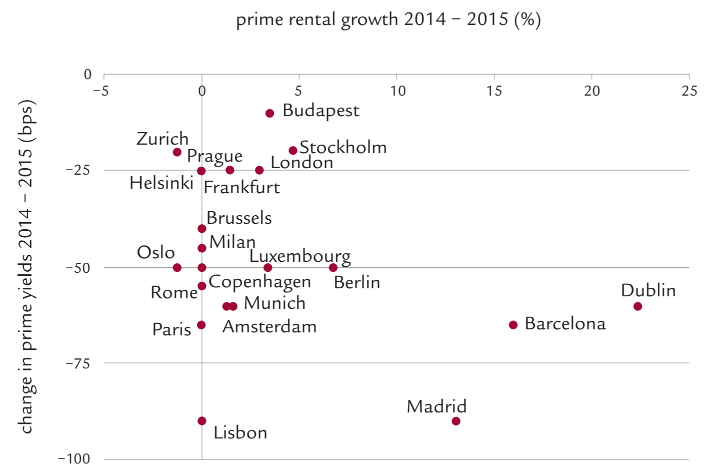
Yield for 10-year government bonds
Yield spread for office (prime) vs. 10-year government bond

Source: PMA, Swiss Life Asset Managers, Corpus Sireo Research

The increase in prices continued in all sectors in 2015. For example, net initial yields in the office sector fell by an average of 45 basis points, with the development ranging from slightly reductions in Budapest or Zurich to significant yield compressions in some southern European markets. Despite historically low levels in many markets, real estate has remained attractive in the current low-interest phase, as shown by the yield premium compared to 10-year government bonds. This is in marked contrast to the last boom: in 2007, net prime yields for (office) properties were lower than the bond level.

However, does this match the fundamental data in relation to the properties, or has the price trend become disconnected from the rental growth? This generally is not the case, as illustrated by the example of office markets: the majority of the markets show a positive correlation between price increases and rent increases.

Major European office markets – development of rents and yields, 2014 – 2015



Source: PMA, Corpus Sireo Research

Rental markets supporting the investment market

Within the context of a general recovery, the development of the major European office markets varied. The "stars" of 2015, with strong increases in take-up, a reduction in vacancies and significant rental growth, were to be found in Spain and Germany. With regards to Paris, prime rents stagnated in spite of rising take-up and reduction of tenant incentives, whereas in London the low level of available space curbed demand but pushed up rents.

Low interest rates and high investment requirements will continue to drive the markets in 2016, with the effect that initial yields are likely to decrease further over the coming months. New records for transaction volumes will largely depend on product availability and on investors' risk appetite. However, some investors are showing an increasing willingness to sell, meaning that market liquidity will not dry up.

Low interest rates and high investment requirements will continue to drive the markets in 2016.

Healthcare Real Estate in Germany

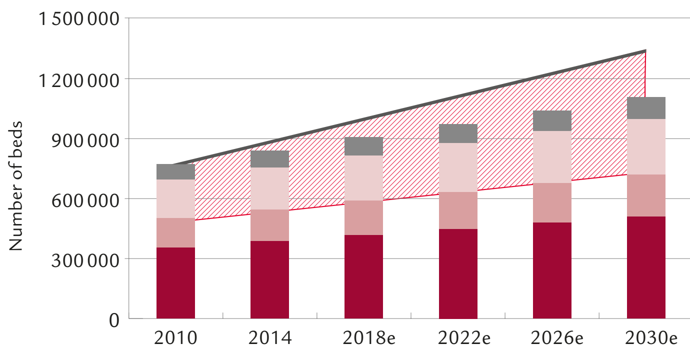
European societies are growing older, resulting in an increasing need for modern infrastructure for healthcare and nursing care. At the same time, governmental financial resources remain limited. There are attractive investment opportunities not only in nursing homes, but also in different types of healthcare properties.

Dr. Andri Eglitis, Head of Research, Corpus Sireo

The conditions are right

As society ages, there are an increasing number of older people who frequently require nursing care. In Germany, the 80+ age group is set to rise by circa 40 % by 2030, which would result in a requirement for approximately 280,000 additional beds or 2,800 homes for nursing care.

Number of and additional requirements for care homes, 2010 – 2030



Supply of beds* (number and quality)

Good | Sufficient | Demand for beds**
Satisfactory | Poor | Shortfall in supply

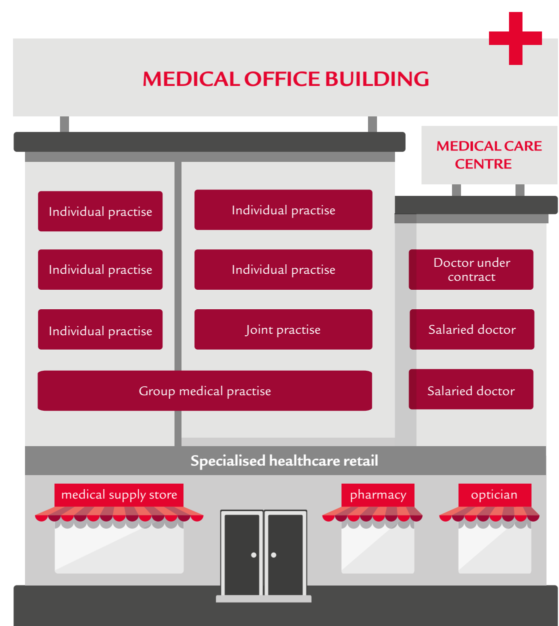
* Inpatient beds
** Inpatient beds and beds for dementia patients

Source: EY, Corpus Sireo

Furthermore a number of nursing home operators, in particular smaller private or non-profit operators, lack the necessary capital for refurbishment arising, for example, from ageing buildings or from changes in the regulatory provisions relating to minimum building requirements. Around a third of all care homes probably do not meet more modern requirements at present. Not including facilities with serious deficiencies in terms of their location or building fabric, there will be a need to modernise circa 1,800 homes by 2030 alone.

Not only nursing care, but healthcare as a whole, is a dynamically growing economic sector. Despite the fact that budgets rise each year, the cost pressure is immense and is encouraging a trend away from inpatient medical care and towards outpatient care. The healthcare reform introduced in Germany in 2004 led to increased interdisciplinary cooperation between (individual) practises and joint organisational models such as medical care centres, which was not only intended to reduce costs due to higher utilisation of medical equipment, but also to enhance the care for patients as a result of medical cooperation. However, in many places there was, and remains a lack of suitable properties. New construction of modern healthcare centres, which enable efficient cooperation between service providers, offers investors an opportunity to enter a growth market.

Example of the structure of a medical office building



Source: Corpus Sireo

Healthcare properties offer investors security due to their stable character and low volatility. Based on a calculable long-term demographic development, firstly there is hardly any dependency on economic cycles, and secondly there is little correlation with other asset classes. In addition, the sector offers long-term rental contracts that usually tend for 15–25 years in the case of nursing homes and 10–15 years in the case of medical office buildings (MOB). Whereas in MOB's a total of 10–25 different tenants ensure diversification,

care homes are operator properties, meaning that the success of such investments depends to a large extent on the operator assessment during purchase due diligence and their ongoing monitoring, which requires many years of expertise on the part of the investment manager.

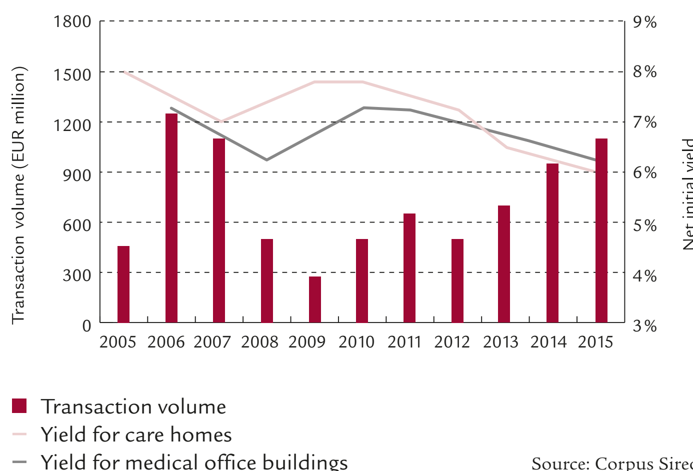
Investments in healthcare properties becoming increasingly established

Owing to the positive economics of the healthcare market, interest among national and international institutional investors is growing. Whereas previously the market had mostly been divided between German and European investors, in 2014 a number of North American investors also entered this market. This growing interest is currently reflected to only a limited extent in the transaction volume, as many investors with considerable investment capital are still waiting on the sidelines for investments.

The transaction volume for nursing homes and MOB's amounted to approximately € 1.1 billion in 2015 after a figure of just under € 1 billion in the previous year. The segments developed differently: whereas investments in MOB's rose significantly to around € 300 million, the number and volume of transactions for care homes were below the previous year's level. These figures do not include assets which are fractionalised, i.e. that sell on individual residential units to private investors. In contrast to the previous year, there was a lack of large portfolio deals on

the institutional market, meaning that take-up focussed on individual properties and small packages that were used to supplement existing portfolios. "The German market" was split equally between domestic and European investors. In the case of care homes, institutional investors came up against new competition: firstly from care home operators, for whom buying is more profitable than leasing in the current interest rate environment, and secondly from family offices and fractionalisers, which are acting in a considerably less price-sensitive manner.

Transaction volumes and net initial yields of care homes and MOB's in Germany



Source: Corpus Sireo

Net initial yields for healthcare properties decreased further in 2015, with the result that top-quality care homes were being traded at around 6.0% on the institutional market at the end of the year. Because MOB's centres pursue different concepts, net initial yields for top properties vary within a range of 6–7%. In the case of care homes requiring renovation, the yield is considerably higher at around 8–10%.

As a result of the generally strong investment market, a significant increase in the transaction volume in the nursing care sector can be expected in 2016. There are a number of fairly large portfolios expecting to be placed to the market which will no doubt encourage international capital to compete. As a result of the continual intense competition for investments, initial yields will remain under pressure. Properties requiring modernisation will become increasingly important, provided they are offered on the market at suitable prices. In general, healthcare properties with different types of uses will continue to become more established.

HOTEL
PLACE DE CLICHY
GARE DU NORD
STALINGRAD

French Hospitality Real Estate Market

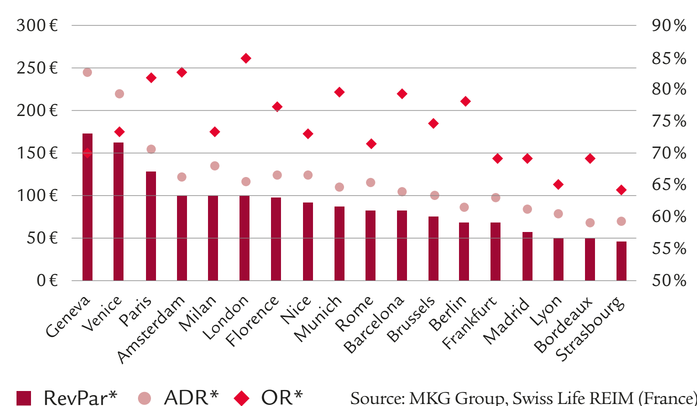
Little known to investors until now, the hotel industry has truly become a fully fledged asset class in the last two years, with strong increases in investments and unflagging performances. What is behind this enthusiasm?

Johanna Capoani, Senior Fund Manager, Swiss Life REIM (France)

Hotel industry highly favoured in France

First, the decline in rates of return is pushing these same investors to move off the beaten track and get involved in other forms of real estate, so that they can achieve sufficient profitability without necessarily changing their risk profile. In addition, these same investors are mature enough to be able to grasp more and more precisely the outlines of such an investment. Finally, the French hotel market presents a number of strengths, with a good mix of products and locations.

2015 performance (at the end of October) of the hotel industry in Europe

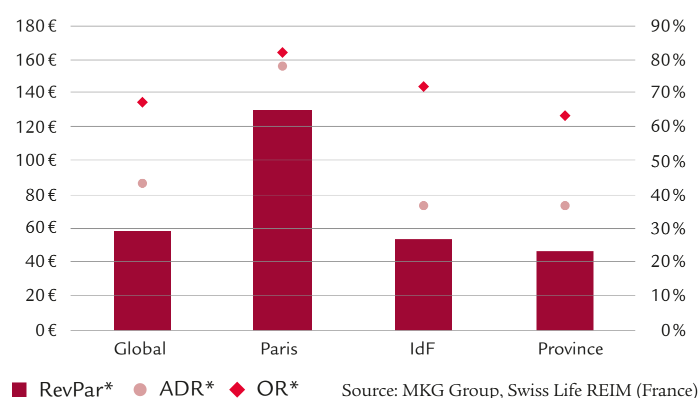


Source: MKG Group, Swiss Life REIM (France)

Paris, leading RevPar in Europe

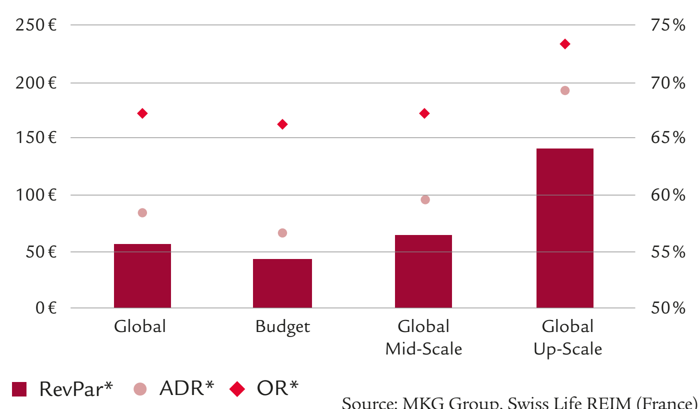
In Europe, at the end of October 2015, most markets have returned to their high levels achieved before the crisis. Large gains have been made in particular in Average Daily Rate (ADR). All hotel categories combined, Paris is ranked third in terms of RevPar*, behind Geneva and Venice. These two small cities have very atypical profiles, one focused on a business clientele, the other solely on leisure, and they are not comparable to the major European capitals. As the top tourist destination in the world with 81.4 million visitors in 2014, France is particularly well positioned in its high-end hotel industry.

2015 performance (at the end of October) of the hotel industry in France by location



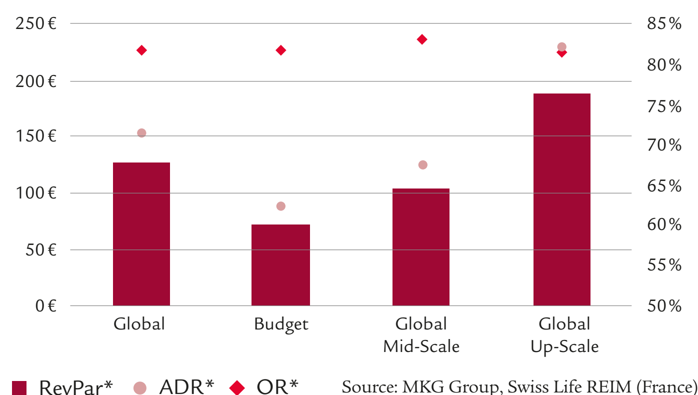
Source: MKG Group, Swiss Life REIM (France)

2015 performance (at the end of October) of the hotel industry in France by category



Source: MKG Group, Swiss Life REIM (France)

2015 performance (at the end of October) of the hotel industry in Paris by category



Source: MKG Group, Swiss Life REIM (France)

* RevPar: Revenue Per Available Room
ADR: Average Daily Rate
OR: Occupation Rate

A mature market with little volatility

The French market is largely driven by Paris and by the high-end hotel industry, with significant disparities in the rest of the country. Paris enjoys a highly comprehensive product mix, with a very broad offering in terms of hotel categories, accompanied by a sub-offering leading to high average occupancy rates (82 % on average in Paris for 2015). Compared to its European neighbours, the Parisian hotel industry has the distinction of being a very mature market with little volatility. This allows it to resist economic crisis, even though it reacts like other cities to more exceptional circumstances, such as the terrorist attacks. This is primarily due to the low volume of new hotel development as well as the diversity of the international clientele, limiting the potential impact of a crisis affecting a country. The volume of hotel transactions nearly doubled in France in 2015: they accounted for 5 % of total investments in France in 2014, compared to 8 % at the end of September 2015.

How should the risk of attacks be integrated?

While the French hotel market finds itself favourably positioned for investment, the fact remains that it was hit hard on two occasions in 2015 by unprecedented attacks that have had a lasting impact on the possible perception of this asset class. However, all post-attack studies conducted in cities that have experienced a similar event (London in 2005, Madrid in 2004, New York in 2001 etc.) show that these attacks had no effect on growth in the medium term. They often lead to cancellations in the following weeks, or even months, but the situation returns to normal within 3 to 6 months, with the possibility of a delayed reaction. In Paris, the repetition of these tragic events could lead to more significant consequences: the latest numbers show reservations down by 30 % in Parisian hotels for the end of 2015, but a reassuring note for the start of 2016, which seems on a better trend.

Interview with Johanna Capoani

Johanna Capoani, Senior Fund Manager,
Swiss Life REIM (France)

In your opinion, which hotel categories should be given priority for investment in France?

Johanna Capoani:
Based on our experience of the hotel industry, as well as our knowledge of the expectations of institutional investors, we favour two hotel categories in France:
- High-end hotels in Paris or Nice, with a favourable mix of tourism/business in order to be exposed to worldwide growth while enjoying a significant local clientele.
- Budget hotels in the rest of the country, more defensive, preferably run under major national or international brands.

These types of assets complement each other with different strategies and target clientele. The Parisian high-end hotel industry will give preference to personalised products, in boutique hotel format, with very accomplished design and prestigious buildings in excellent locations. The budget hotel industry calls on standardised, franchised products, located at the periphery of moderate-sized French cities.

What about hotel performances in France in 2015?

Johanna Capoani:
The year 2015 was marked by a recovering economic environment and a return to growth. However the hotel sector was affected by two unprecedented waves of attacks. RevPar for France showed good resilience with Up-scale hotel segment RevPar (+1.7 % according to Deloitte) and budget hotel RevPar (+0.1 %) showing a rising trend, confirming our strategy. If we look at Paris, RevPar is down, which makes sense given the context. On the contrary, the French Riviera and French regions in general have offered good resistance with RevPar rising sharply, except for the super-budget segment.

What will be the driving forces in the hotel industry in 2016?

Johanna Capoani:
Modes of consumption are all undergoing profound changes. The principal challenge for the hotel industry in 2016 will certainly be the major transformation of this sector in general, notably in relation to competition from new accommodation options. The entry of new players is pushing hotels to challenge their business model to create unique experiences which should enable them to stand out from collaborative accommodation.

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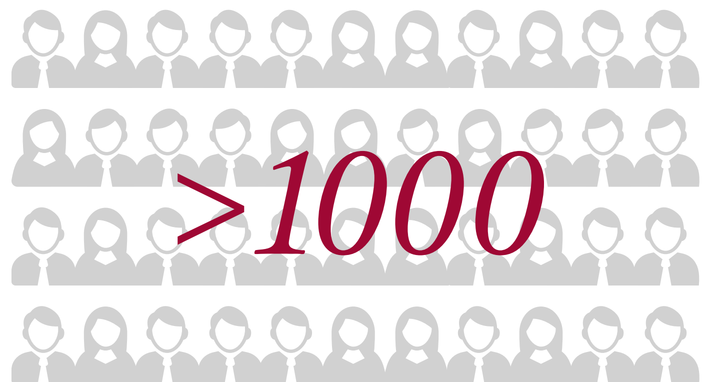
Real Estate – Facts and Figures

Assets under management and administration

(in CHF bn)	AuM	REuA*		AuMA**
Total	185.3	28.6		213.9
Real Estate	36.7			Total REuMA***
Corpus Sireo	2.3	12.0		
Livit		16.6		67.6

*Real Estate under Administration **Assets under Management and Administration
***Real Estate under Management and Administration

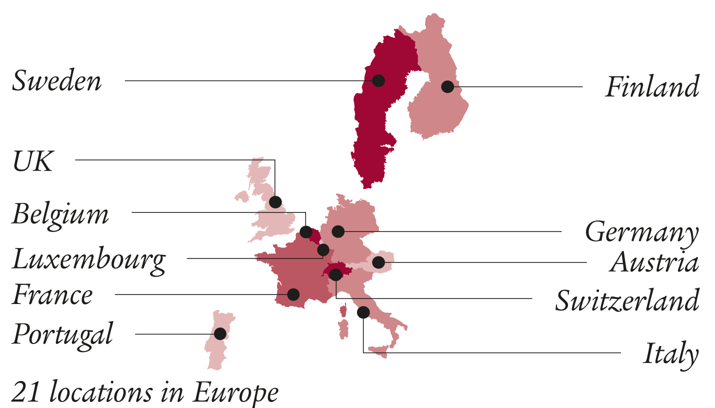
Employees



Transaction volume real estate

(in CHF bn)

Strong footprint in Europe – our investment universe



All figures at 31 December 2015 unless stated otherwise

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Impressum: ***Publisher:*** Swiss Life Asset Management AG, General-Guisan-Quai 40, 8022 Zurich • ***Editorial Board:*** Marcel Weiler/Swiss Life Asset Managers, Sylvia Walter/Swiss Life Asset Managers, Carine Quentin/Swiss Life REIM (France), Johanna Capoani Offredi/Swiss Life REIM (France), Dr. Andri Eglitis/CORPUS SIREO, Harry Hohoff/CORPUS SIREO • ***Layout/Design:*** The PR Factory, Dolderstrasse 17, 8032 Zurich • ***Pictures:*** Archives Swiss Life Asset Managers, Swiss Life REIM (France), CORPUS SIREO, ez_thug/iStockphoto.com (p. 3), PPAMPictur/iStockphoto.com (p. 4), Nikada/iStockphoto.com (p. 5), TommL/iStockphoto.com (p. 7) • ***Periodicity:*** Twice a year

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