A supplement to *The Institutional Real Estate Letter – Europe*

THE INSTITUTIONAL REAL ESTATE LETTER – EUROPE

Sponsor Viewpoint

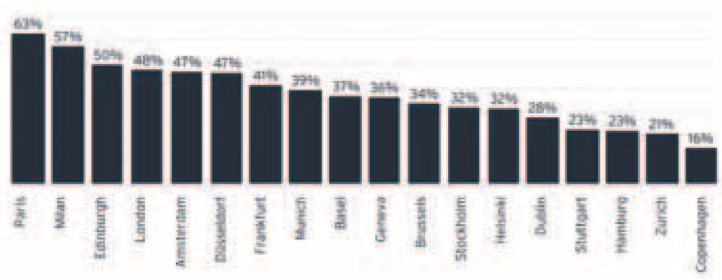
TIAA Henderson Real Estate

Paris

Challenging market conditions and evolving investor requirements mean we are increasingly looking at longer-term drivers of real estate performance. Megatrends — notably urbanisation, rising middle classes, ageing population, technology and the shift of economic power from the West — are having a major impact on the built environment and will have significant implications on demand for real estate. These trends are now an important component of our global research; we have analysts assigned to understanding each of them. While short-term performance of real estate will continue to be determined by economic cycles, there is a risk that these will mask longer-term erosion of value as megatrends play out. And, conversely, ignoring long-term structural trends in favour of short-term gain will see missed opportunities.

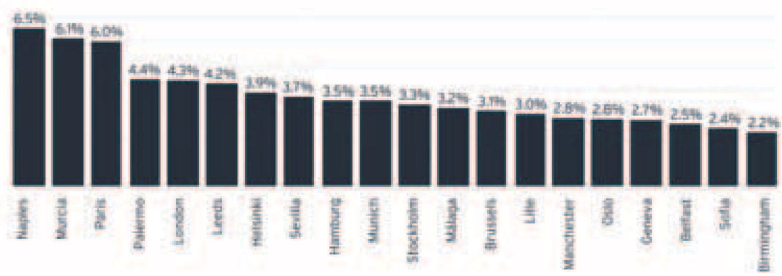
As we have explored these megatrends, it has become apparent

Fig. 1: Cities are more productive (GDP per capita, difference to national level)



Source: Oxford Economics, 2014

Fig. 2: Cities are younger (proportion of population under 40, difference to national level)



Source: Oxford Economics, 2014

London

that their impact will be much more notable, for better or worse, at the city level, as opposed to nationally. And, therefore, our global strategic advice is now centred on cities not countries. This approach is consistent with the way occupiers think about their requirements and representation. It means that compelling opportunities do not get missed due to negative country-level perception, and vice versa.

We have adopted an innovative, two-pronged approach to top-down analysis, capturing both structural megatrends and tactical real estate fundamentals, to identify future-proof cities.

Breaking down Europe

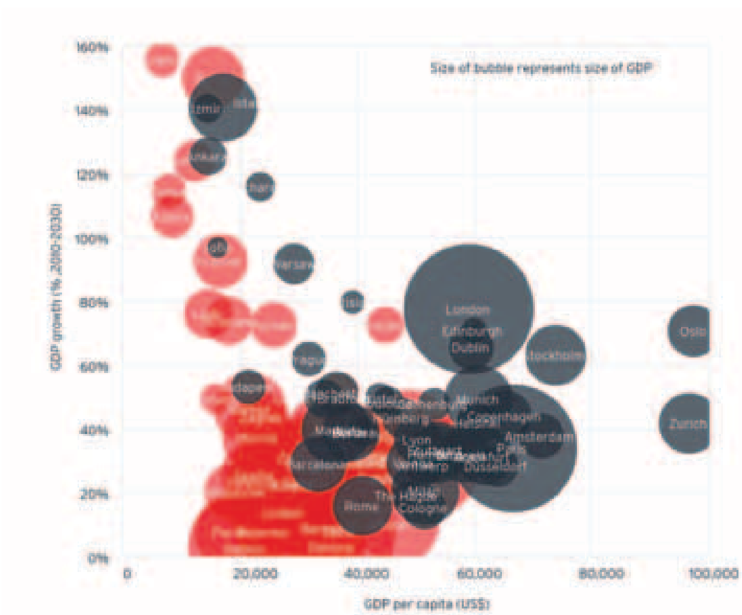
We have scored over 200 European cities according to the qualities that make them attractive to people and occupiers, today and in the future. This first stage of our filter process is not about real estate investment fundamentals, but purely about finding future-proof cities, economically and environmentally. Cities are scored according to their size, affluence, age profile, willingness to embrace technology and quality of life. And as we are looking for long-term investment opportunities, they are also scored according to the growth potential for all of the above.

This approach is not at the exclusion of traditional measures of real estate attractiveness. We also filter all the cities through our global risk model, which scores locations according to liquidity, transparency, income security and volatility; again, all long-term measures of attractiveness.

This process has helped us filter over 200 cities in Europe, down to under 50. We believe these cities have the ability to attract talent, tourists and international tenants, based on long-term fundamentals. They are then grouped according to their real estate fundamentals and growth prospects.

We place a greater emphasis on those cities that score well on key fundamentals today (Defensive Cities), and naturally want to focus on those that score well both today and tomorrow (Defensive Growth Cities). These are leading cities today that we expect to capture an even greater share of

Fig. 3: GDP per capita (growth and size)



Source: Oxford Economics, 2014

global output and demand in the future.

There are also cities which do not score well in traditional real estate terms today, due to illiquidity, lack of transparency or market size, but whose growth rates cannot be ignored (Growth Cities). These are the cities that are expected to see their position in the hierarchy change markedly over the next couple of decades, in terms of economic output or consumer demand. In turn, they should see their perception as real estate investment markets improve and enjoy, over the longer term, a structural correction in both rents and yields. Investments in these markets need to be highly selective but made smartly ahead of the curve to enhance portfolio returns.

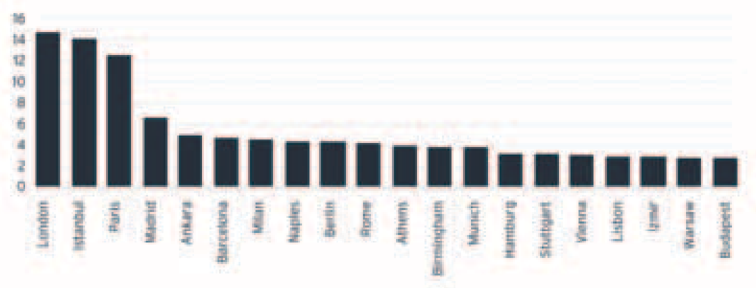
In all categories, we classify cities as Tier 1 and Tier 2. This predominantly relates to their size and the scale of opportunity we see there, rather than their attractiveness. We would anticipate a pan-European portfolio being biased toward Tier 1 Cities in the Defensive and Defensive Growth categories based on market size and risk profile.

An obvious question here is: Why would we not just focus on perhaps the 10 largest Defensive/Defensive Growth Cities?

Diversification

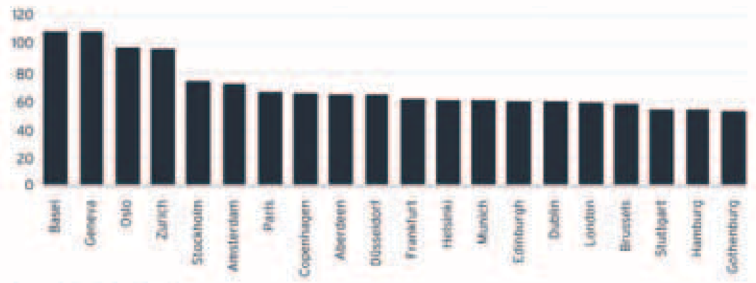
In addition to identifying long-term performance, we also want to maximise the benefits of diversification, by location, sector and drivers of demand. The largest real estate markets are typically closely correlated, driven by financial and business services, and so offer little benefit to geographical diversification. Seeking a balance of occupiers by industry should help lower volatility of rental growth and avoid overdependence on any one sector. Investments underpinned by financial and business services, for example, should be complemented with investments in resource or commodity-led economies. Our Tier 2 and Growth Cities

Fig. 4: Scale, population (million, 2014)



Source: Oxford Economics, 2014

Fig. 5: Productivity: GDP per capita (US$, '000s, 2014)

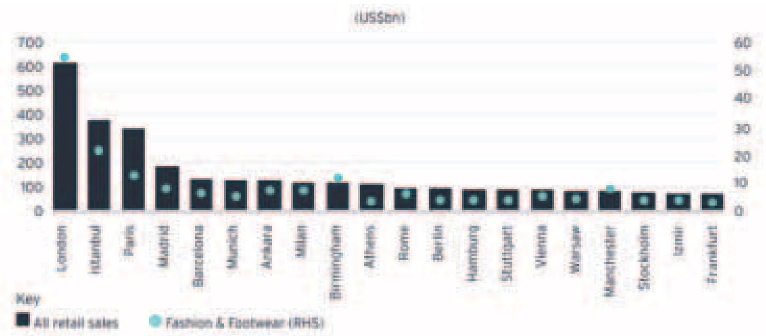


Source: Oxford Economics, 2014

Fig. 6: Fastest growing cities: GDP growth (% change, 2010–2030)

Source: Oxford Economics, 2014

Fig. 7: Tomorrow's world cities: size of retail market 2030 (US$b)



Source: Oxford Economics, 2014

tend to offer greater diversification benefits to real estate investors and — in the case of the Growth Cities — should also enhance returns.

Investing across different real estate sectors can offer further diversification benefits. Not all our cities are appropriate for all sectors, and for some we might only target one sector, actively avoiding others. Broadly speaking, the Tier 1 Cities should be attractive for all sectors, while in the Tier 2 Cities, we would target either retail or logistics. The Growth Cities will likely be reserved for retail only, their growth really being underpinned by consumer and tourist economies.

Istanbul

Market timing

While we advocate a top-down strategy that is underpinned by long-term fundamentals, structural growth and risk management, of course, there is an important role for market timing, cycles and short-term pricing in day-to-day portfolio management. At any one point in time, some markets will look more attractive than others based on where they are in their cycle. And so, while our universe of 46 cities will remain unchanged, our short- to medium-term buy, or indeed sell, priorities will change regularly to enhance performance via early cycle entry. We conduct five-year, sector-level city forecasts for all of our Defensive and Defensive Growth Cities. Forecasting the Growth Cities is more of a challenge, but the opportunity in these markets is structural rather than cyclical, meaning short-term forecasts are less relevant. For all cities, our Global Risk Model gives us a required return hurdle allowing us to assess the attractiveness of opportunities.

A city-based real estate strategy, underpinned by long-term, structural trends, that strikes the right balance of risk and diversification, while taking advantage of short-term pricing opportunities, should enjoy above-average portfolio level returns, lower-than-average volatility and modest downside risk for long-term investors. ❖

CORPORATE OVERVIEW

TIAA Henderson Real Estate (TH Real Estate) is a global real estate asset management firm with specialisation in real estate equity and debt investing worldwide. As one of the largest real estate managers in the world, TH Real Estate has the scale, capital resources and knowledge to provide creative and effective real estate investment solutions for clients. With a focus on the retail, office, logistics, debt and multifamily sectors, TH Real Estate emphasises sustainable practices to protect assets and maximise their value.

The company is jointly owned by TIAA-CREF (60 percent) and Henderson Global Investors (40 percent) creating a combined track record of over 90 years in global real estate. Its products are managed by specialist teams, which apply their own experience to the management and style of their portfolios. Each team is supported by an experienced senior management team and integrated investment platform, including finance, debt and currency management, performance analytics, client service, fund and transaction structuring, development, sustainability and research.

Launched in April 2014, the company has a dedicated global presence with offices across Europe, North America and Asia. Combining TIAA-CREF's existing US platform, with TH Real Estate's deep penetration across Europe and Asia, has created a platform in excess of $82 billion (as of 31 December 2014).

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