AEW RESEARCH

2020 Global Strategy Perspective

AEW

RESEARCH CONTACTS

MICHAEL ACTON, CFA®
Head of Research
North America
Michael.Acton@aew.com
+1 617 261 9577

GLYN NELSON
Head of Research
Asia Pacific
Glyn.Nelson@aew.com
+65 6303 9016

HANS VRENSEN, CFA®, CRE
Head of Research
Europe
Hans.Vrensen@eu.aew.com
+44 (0) 20 7016 4753

TABLE OF CONTENTS

Introduction 3
Executive Summary 3
Global Trends: Low Growth Offset by Positives 4
Investment Market Outlook: Relative Value Attracts Capital 14

AEW

Prepared by AEW Research, January 2020

2020 Global Strategy Perspective

Introduction

As we start the third decade of the 21st century, it is an opportune time to take stock of real estate markets around the world. Despite the aftershocks of the global financial crisis, most investors have taken advantage of real estate opportunities outside their home markets. At AEW we have been working with international investors for nearly 40 years. In this report, we share our perspective on global investment markets, considering both global trends and occupier market trends.

Executive Summary

- Global economic policy, demographic and political factors suggest a structurally lower economic growth rate going forward across most developed markets. But, positive factors such as lower required rates of returns, more conservative debt levels and a limited supply reaction still leave real estate in a better place — both relative to other asset classes and relative to past real estate cycles.

- Occupier markets are adjusting and going through their own structural shifts. Technological changes continue to impact demand for different types of space. Many headlines have focused on how traditional retail formats are being eroded by on-line platforms. Yet demand for logistics/industrial space has benefited from the same underlying consumer need for same day delivery.

- Investment capital targeting real estate remains at near-record highs. Allocations to the sector are rising and many investors are below their targets. Global real estate capital is broadening from core to non-core investments. New ESG-compliant developments can offer attractive value-add opportunities. Logistics/industrial offers good growth globally and cyclical downturns in some office markets is providing attractive entry opportunities.

Global Trends

After broadly examining the state of the global market, we have found some compelling similarities that will impact how we plan our investment roadmap over the coming year and beyond. The shared themes across our investment regions are slow moving and difficult to reverse. They include structural demographic changes, slowing economic growth, coordinated central bank policies, extreme policy uncertainty and ESG factors. All these trends impact asset allocation policies and preferences.

Here are the five overriding themes across the U.S., Europe and Asia Pacific:

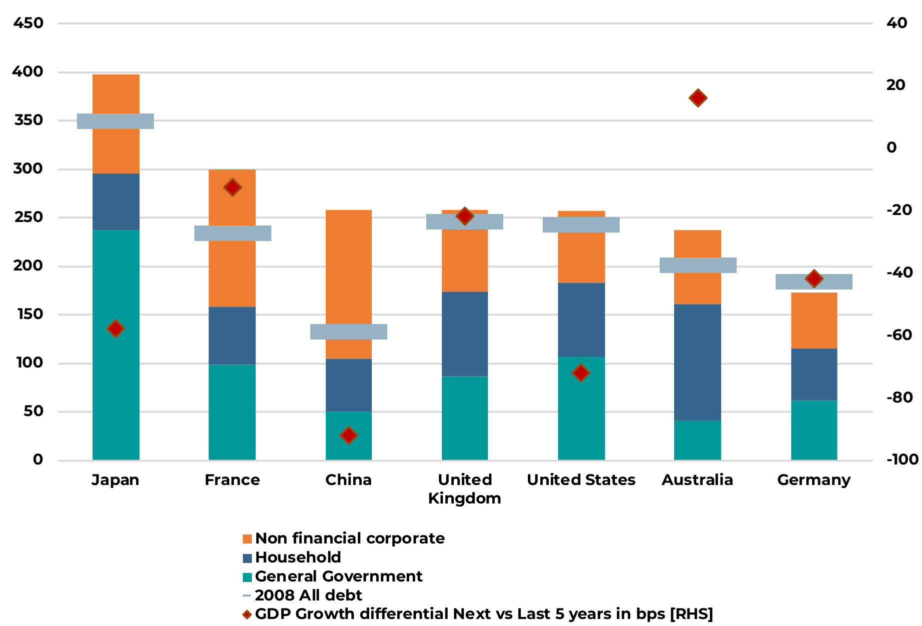
1 LOWER ECONOMIC GROWTH: THE NEW NORMAL?

After one of the longest recoveries following the Global Financial Crisis (G.F.C.), we are now seeing a slowdown in economic growth. In fact, Australia is the only leading economy with higher growth in the next five years compared to the prior five years. The U.S.-China so-called "Phase One" trade deal indicates an improvement in relationships and has already bettered sentiment. That said, investors will want to plan for a more subdued growth outlook in many of the advanced economies, despite the 2020 outlook being better than 2019.

It is hard to see where the next big push for global growth will come from, especially with many governments' debt still above pre-G.F.C. levels. This means that despite low interest rates, fiscal stimulus is not widely available to revive growth across most western countries, but we do note a supportive fiscal response in many Asia Pacific countries, which will likely remain as an offset to regional risk associated with COVID-19 (Coronavirus). With productivity growth also at historically low levels, contradicting steady advances in innovation, consensus forecasts show slowing GDP growth for the next five years. This means that demand for real estate space is likely to grow more slowly.

FIGURE 1

DEBT LEVEL IN 2008 AND 2018 (AS % OF GDP) AND REDUCTION IN GDP GROWTH IN BASIS POINTS PER ANNUM FOR NEXT FIVE YEARS VS PRIOR FIVE YEARS (RHS)



Sources: IMF & AEW

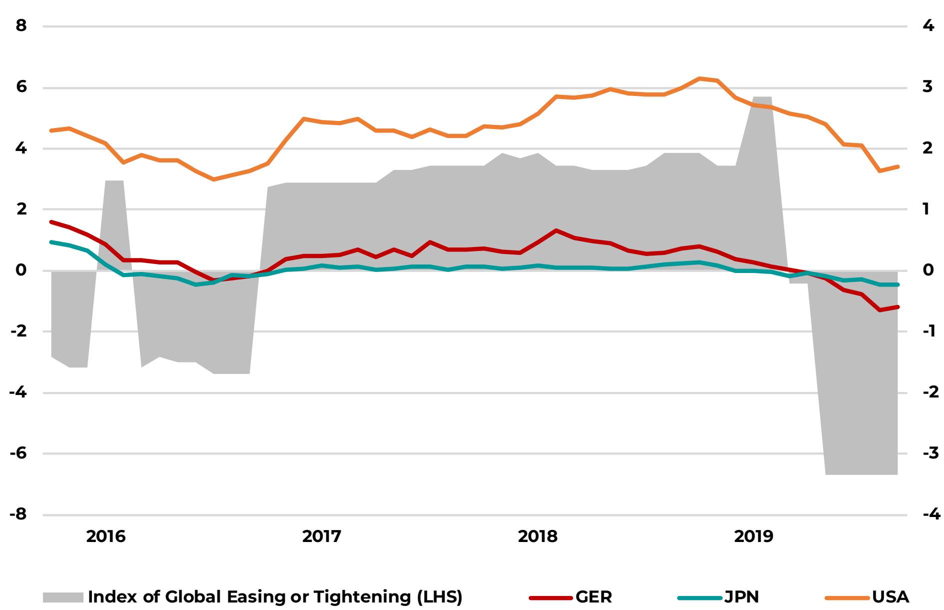
2 MONETARY POLICY DRIVES GOVERNMENT BOND YIELDS AND HURDLES RATE LOWER

In response to the recent economic slowdown and low inflation, central bankers reversed monetary policies in late 2018 and 2019. The chart below illustrates an unprecedented level of global monetary policy easing (grey shaded area).

Led by the Federal Reserve, global central banks have cut policy rates and resumed quantitative easing in response to a slowdown in economic growth triggering significant tightening of government bond yields as investors seek safe harbor investments and limited bonds that are available in the secondary markets. Given that real estate competes for capital with other assets, low bond yields also lower the hurdle rate most investors require for taking real estate specific risks. This is actually helping our asset class in relative terms.

In addition, central banks around the world have introduced stricter reserve requirements for banks and other lenders, which has kept lending to commercial real estate more conservative compared to previous market cycles. This has also meant more risky speculative development activity has not been funded by banks as much as in the past, reducing the risk of oversupply in the occupier markets. This more restricted supply of space offers global real estate investors a more stable, long-term investment environment than before.

FIGURE 2
CENTRAL BANK EASING/TIGHTENING



Sources: CFR, OECD & AEW

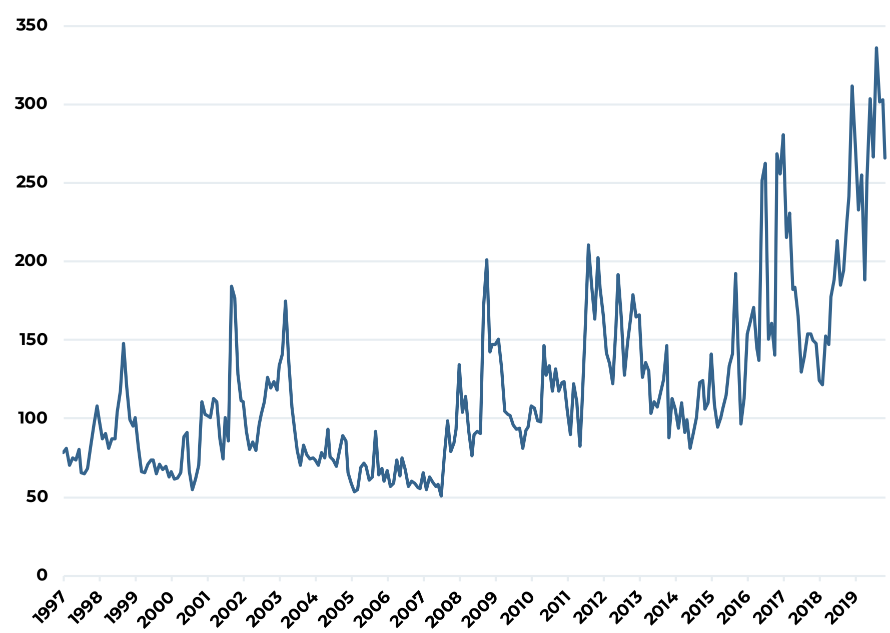
3 ELEVATED POLITICAL UNCERTAINTY CONTINUES, BUT WITH A GLIMPSE OF RESOLVE IN 2020

Outsized political uncertainty has been a persistent concern for investors for some time now. Much of this concern has centered specifically around international trade. Three specific developments in recent months may well presage a broader normalization:

- Small scale, but significant easing of U.S. trade tensions with China have emerged with the so-called "Phase One" trade agreement. However, Europe could be a potential next target for U.S. trade policy.
- The large Conservative electoral margin in Britain and the subsequent Brexit vote in Parliament seem to clarify Britain will indeed move ahead with its European exit in 2020. But, the self-imposed UK deadline of year-end 2020 could still trigger a no-deal Brexit.
- The U.S. House of Representatives and Senate overwhelmingly approved the revised North American Free Trade Agreement, now known as the U.S.-Mexico-Canada agreement (USMCA).

However, significant unease remains in many parts of the world. More recently the global outbreak of the COVID-19 will likely cause disruption to the global services outlook through reduced travel and spending as well as affecting supply chains.

FIGURE 3
GLOBAL POLICY UNCERTAINTY



Source: Economic Policy Uncertainty (policyuncertainty.com)[1]

[1]Davis, Steven J., 2016. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review, October.

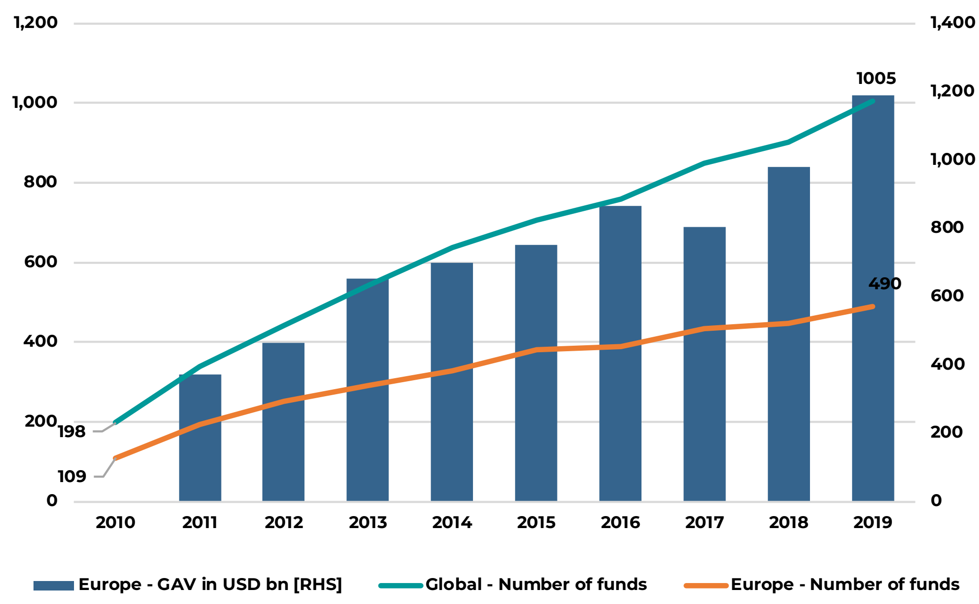
4 CLIMATE CHANGE AND ESG

Focus on ESG in real estate has increased significantly and broadened as a worldwide endeavor over the last two years. As proof, in 2019, the Oxford word of the year was "climate emergency", Dictionary.com cited "existential" and *Time Magazine* chose Swedish teenager and climate activist, Greta Thunberg, as their most influential person of the year.

GRESB has become mainstream as an ESG real estate fund benchmark, with the number of funds covered increasing from 198 in 2010 to 1,005 in 2019. Due to Europe's early implementation of green initiatives, this region is the most represented region in GRESB with 490 real estate funds, totaling USD $1.2 T of Gross Asset Value (G.A.V.). In addition, evidence from the REIT markets suggests that investors do not need to sacrifice returns to invest in green certified and energy efficient buildings.

New initiatives using building-level data can also help avoid potential bias in a self-reporting survey. As investors come to grips with potentially higher capital expenditures to meet stricter future ESG regulations, it is likely that asset prices will need to rebalance. This offers opportunities for professional managers to add value.

FIGURE 4
GRESB FUNDS AND GAV BREAKDOWN

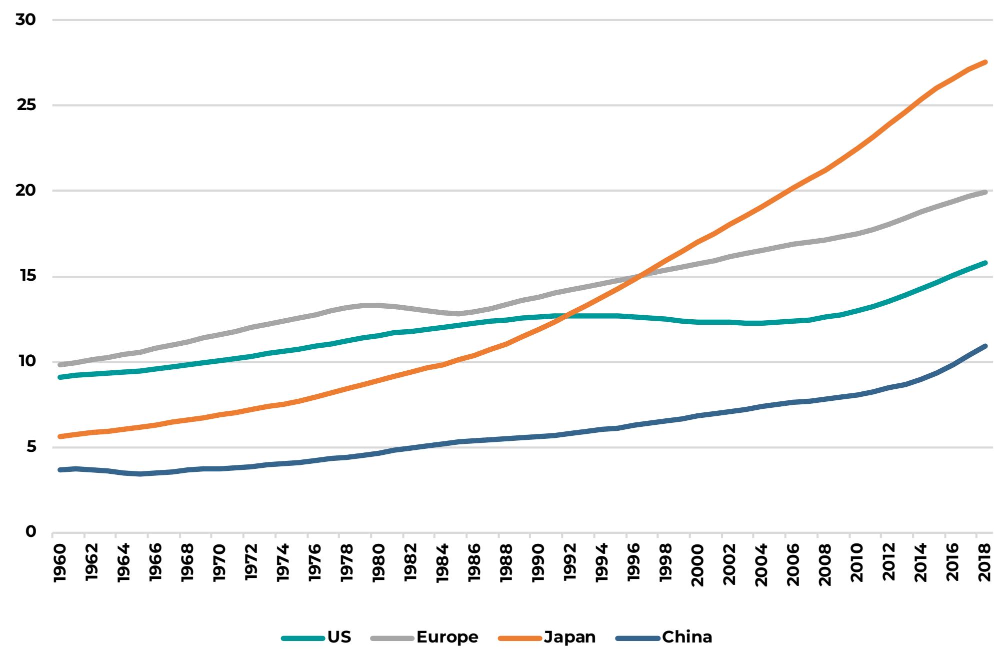


Sources: GRESB, FTSE Russell & AEW

5 POPULATION: AGING FAST AND GROWING SLOWLY

The world's population is aging rapidly and growing at a slower pace for various reasons. These include medical advances and better lifestyles pushing up longevity while cultural factors push down birth rates. This is true in the U.S., most of Europe, China and Japan. Recent U.S. Census Bureau data shows population growth over the last year at the lowest level in more than a century. Similar data for Japan confirms total births falling to the lowest level since records began in 1899 and total population decline surpassing 500,000 for the first time in history. In addition, increased income and wealth inequality has triggered a potentially misplaced resistance to immigration, further pushing down population growth in both the U.S. and Europe. As most people live longer and many also work longer, we might need not only more, but also different places to work and live. Real estate development focus has started shifting away from single-purpose buildings towards multi-use, integrated uses. In addition, AEW anticipates structural demand for segments such as senior housing and medical offices.

FIGURE 5
SHARE OF POPULATION OVER AGE 65



Source: World Bank

Occupier Market Trends: E-commerce & Tech at the Forefront

Apart from demand and supply being driven by these trends, there are more specific structural changes in the occupier markets. The continuing rise of e-commerce around the globe and its effect on retail and logistics/industrial space is a key theme.

RETAIL

Retail continues to be dominated by negative news, as many traditional and well known department store retailers fail or are forced to renegotiate lower rents. The U.S. and U.K. have been at the forefront of this global trend.

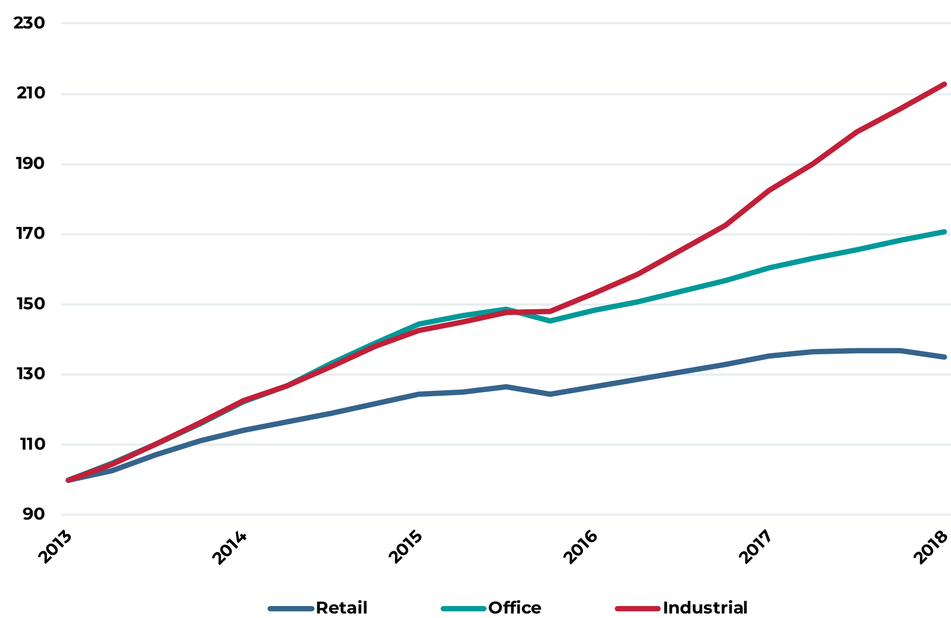
EUROPE

E-commerce has blossomed for retail in the U.K., but it may offer value-add opportunities as it has in other parts of the world. As e-commerce has taken a larger share of retail sales returns, retail values have decreased similarly to those in the U.S.

Many traditional retailers are forced to renegotiate lower rents to avoid failing. This negative sentiment has been reflected in much lower returns than the other property types in the U.K. since 2013. More repricing might still be needed and many retail assets can be repositioned or redeveloped into mixed use projects offering attractive value-add opportunities.

U.K. secondary high street retail markets and shopping centers have had significant downward value adjustments and might be ripe for value-add conversion strategies.

FIGURE 6
U.K. PRIME PROPERTY TYPE RETURNS (INDEXED 2013 = 100)

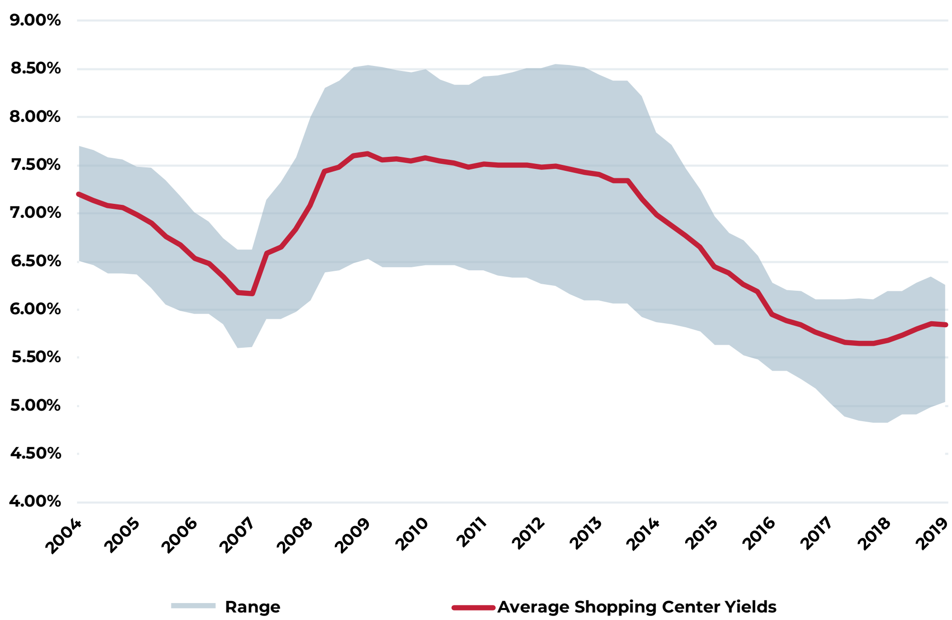


Sources: AEW & CBRE

ASIA PACIFIC

For longer-term investors, the repricing of shopping centers in Australia may present a compelling investment, especially in a world where government bond yields are so low. With entry yields possibly 6.5% to 7.0% and accretive leverage, cash returns on equity could be persuasive. Whether the pricing is appropriate will be down to the target assets fundamentals, especially its rent roll and capital expenditure program. Often there is a repurposing aspect to these assets as large anchor tenants (department stores and discount department stores) may not renew at expiry. In the balance of the Asia Pacific region, neighborhood shopping assets catering to daily spending habits of local consumers will continue to be defensive against the sector's headwinds.

FIGURE 7
AUSTRALIA SHOPPING CENTER YIELDS



Source: JLL

U.S.

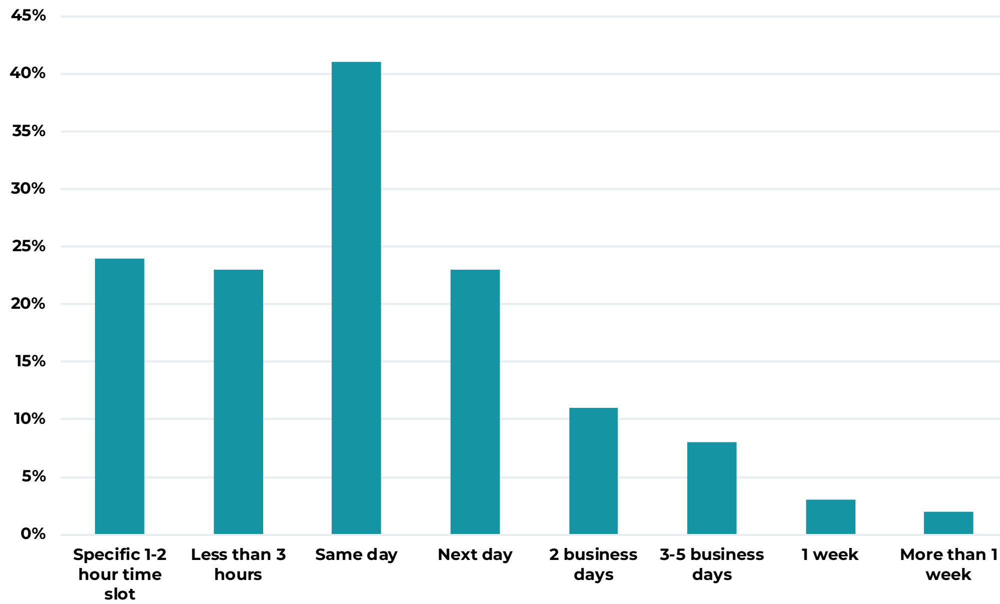
Retail has become a one-sided trade with an aggregate perception that all retail is "bad" while different segments of the market flourish as the retail model changes. Successful centers are those able to retain relevant anchor tenants effectuating a successful omni-channel presence in the market or those that have successfully realigned their tenant mix with more services and/or convenience-based necessities less exposed to the e-commerce effects. Still, shifting consumer demand for goods and services, the continued evolution of the omni-channel model, and the resetting of expectations for speed and access created by e-commerce present material challenges for bricks and mortar retail. With the investment community broad brushing the retail sector with skepticism, the investment potential for success will most likely be finding mispriced assets resulting from capital market dislocations.

LOGISTICS & INDUSTRIAL

EUROPE

Consumers are increasingly willing to pay for shorter delivery times. This demand in turn triggers demand for urban logistics across Europe's largest cities.
Parcel delivery and third party logistics firms demand logistics space in urban areas using three criteria levels: (1) larger logistics parks near main highways; (2) large cross-docking facilities near multi-modal hubs; and (3) local redistribution hubs inside urban centers, for local deliveries. Developing urban sites or converting existing uses for urban logistics parks, facilities or hubs should prove an attractive opportunity for investors.

FIGURE 8
CONSUMER DELIVERY PREFERENCES



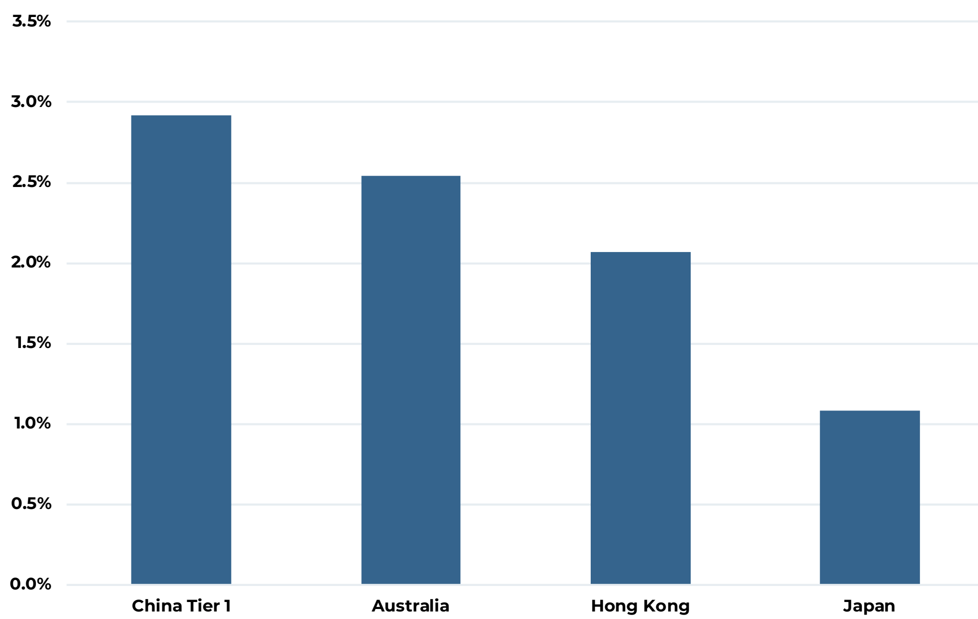
Sources: Pwc Consumer Survey & AEW
As of 12/31/19

ASIA PACIFIC

Similar to other regions, the logistics sector in Asia Pacific is benefitting from changing consumption patterns. There are areas of new opportunity throughout the region, including last mile and cold storage facilities. These have support from robust domestic consumption, the move towards omnichannel retailing, and supply chain changes creating shorter delivery times and enabling fresh/frozen goods delivery.

More broadly, there is strong support for business parks which typically cater for technology and development centered occupiers. This is consistent with focusing on domestic demand drivers.

FIGURE 9
ASIA PACIFIC LOGISTICS AVERAGE RENTAL GROWTH FORECAST PER ANNUM 2020 TO 2022



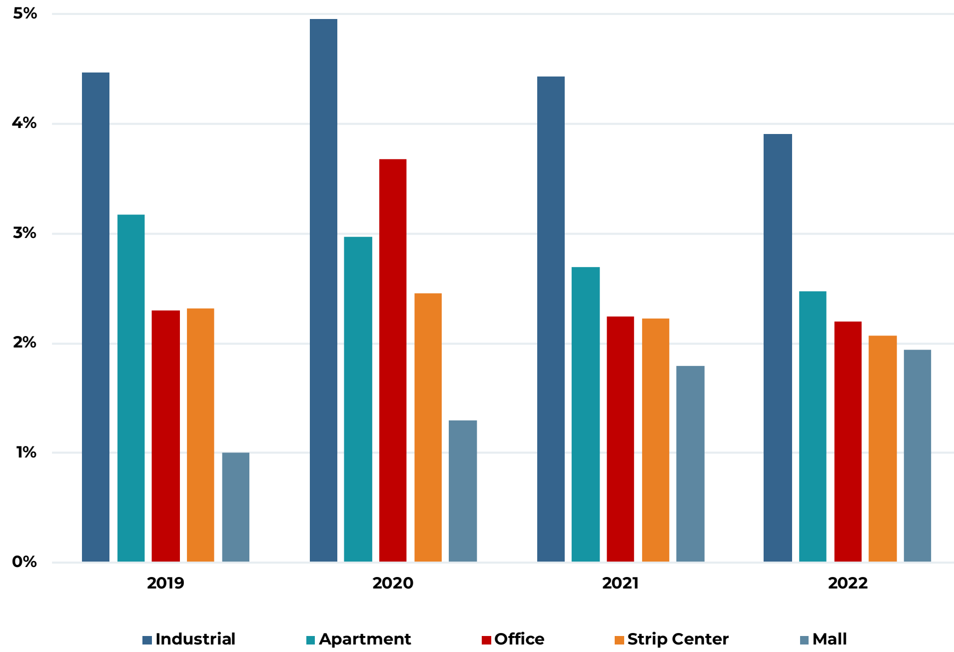
Source: PMA
As of 12/31/19

U.S.

Industrial continues to steal demand from retail with e-commerce driving rents in previously "obsolete" locations and altering the perception of building quality in infill locations while superfluous retail is being repositioned into higher and better use. Most new construction has been bulk distribution and industrial assets larger than 250,000 square feet primarily on the outskirts of cities with good highway access where land is more readily available. The supply response to this increasing demand will have to be monitored, particularly in these larger asset sub-markets.

Available infill locations for new assets of almost any size are difficult to find with redevelopment opportunities of older assets often shifting to higher and better uses, often apartments or creative office.

FIGURE 10
U.S. EXPECTED NOI GROWTH



Source: Green Street
As of 12/31/19

OFFICES

Headlines surrounding the failed WeWork IPO highlight challenges in meeting the structural shift in office demand for more flexible working space. Technology has played a key role in this shift. In light of new disrupters, traditional landlords have started to adopt new tenant-facing apps to meet their need for more frequent interaction and related services.

Globally, there is strong demand and rental growth in supply constrained CBD markets. Most 24-hour cities have been successful in attracting large and growing tech companies and the talent they employ. This has reversed some of the suburbanization in the office markets over the past decades, but affordability of housing and limits to transport systems in traditional CBD markets might limit this reurbanization trend in coming years.

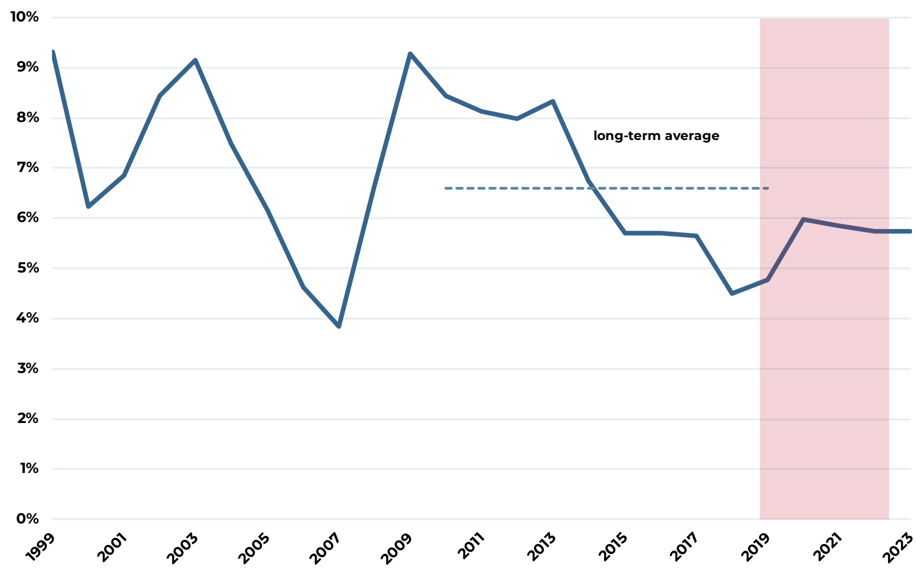
EUROPE

Vacancy rates in the European office sector have compressed substantially over the last years amid limited new supply. This has resulted in strong rental growth of near 4% per annum over the last three years. However, as we are expecting slowing economic growth to impact demand for office space, we adjusted our forecast for rental growth down to 3% per annum across the near 60 markets in our coverage. Supply of new buildings has been limited as higher reserve requirements for banks prevented them to do any lending for purely speculative new developments. This had been a cause for oversupply in previous market cycles.

ASIA PACIFIC

Office markets across the Asia Pacific are typically characterized by low vacancy rates, under long-term averages. That said, there are pockets of higher vacancy as supply is delivered, but often this is transitory and readily absorbed. New construction has been kept under control in recent years with stock increases across the key gateway markets at about 3% per annum over the past three years. This will continue for 2020 and is forecast to drop to under 2% in 2021. AEW continues to prefer defensive office strategies in Australia, Tier I China, Seoul and Japan.

FIGURE 11
ASIA PACIFIC PRIME OFFICE AVERAGE VACANCY TREND



Sources: JLL and PMA
As of 12/31/19

U.S.

The U.S. office market has enjoyed a late cycle surge in absorption resulting from the pick-up in employment growth in 2018. With employment growth slowing during 2019, we expect this recent acceleration in demand to moderate in 2020 and 2021. Growth in the office stock, however, remains quite tame, particularly relative to prior cycles. As a result, the national average office vacancy rate continues to edge down to approximately 12%, the lowest level since 2001. With more moderate absorption likely, investor focus continues to be on the high capital expenditures burden in the sector. NCREIF data show more than half of all office net operating income going back into properties, partially resulting from below trend capital investment in the years immediately following the financial crisis and partially in response to evolving tenant demands for space configuration.

Investment Market Outlook: Relative Value Attracts Capital

AVAILABLE CAPITAL AT NEAR RECORD LEVELS

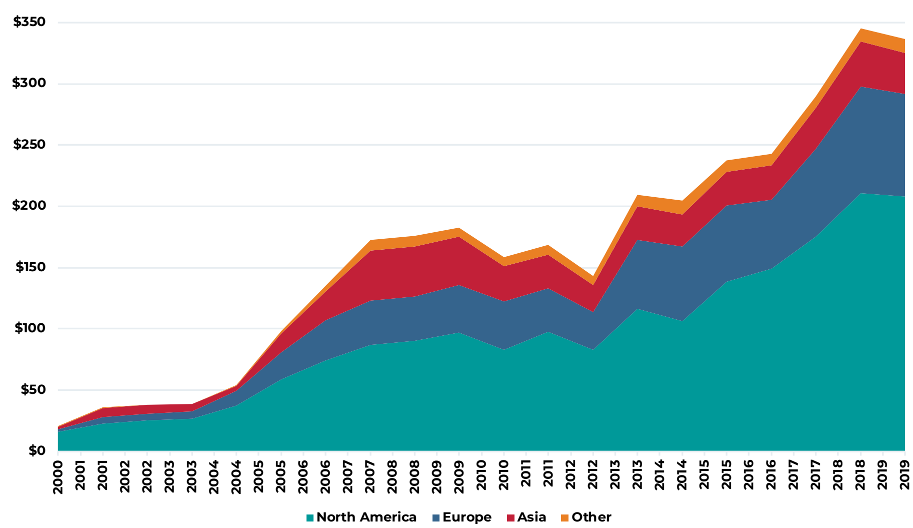
Most asset class valuations today are high by any conventional metric. Central banks have historically used monetary policy to pull forward demand to combat weakened economies. Over this past decade, these same banks have applied monetary policy to pull forward asset appreciation to deleverage an over-leveraged world.

As such, go forward expected returns across most asset classes will simply be lower, most likely for a longer period than most of us would care to acknowledge. All investing is ultimately an exercise in relative valuation and, in this context, real estate looks attractive to most investors. The characteristics of property returns – stable cash flow and appreciation in line with inflation – are very much in demand. Recent survey data show nearly all institutional investors maintaining or increasing allocations to real estate with a growing share of the real estate allocation going to higher risk and return strategies.[2] At the same time, many investors remain below target allocations as the denominator effect increases as equity markets relentlessly march forward.

The struggle to move towards higher allocations has resulted in significant capital raising and large amounts of dry powder capital. Globally, Preqin estimates more than $325 billion of capital in funds alone waiting on the sidelines today compared with less than $200 billion in 2014 and roughly half as much in 2007 on the eve of the financial crisis. The weight of capital is, as always, a two-edged sword, making the investment market both more competitive, but also more liquid. Not surprisingly, most of this capital has been raised in higher return seeking strategies (i.e. value-add and opportunistic vehicles) which share the unique characteristics of being largely closed-end where the investment period clock has already begun ticking. This capital will be invested over the next 2-3 years, along with significant additional capital being raised for PERE in the under-allocated retail/HNW investor segment, which should provide a solid foundation in further support of today's valuations.

FIGURE 12

REAL ESTATE DRY POWDER CAPITAL BY REGION

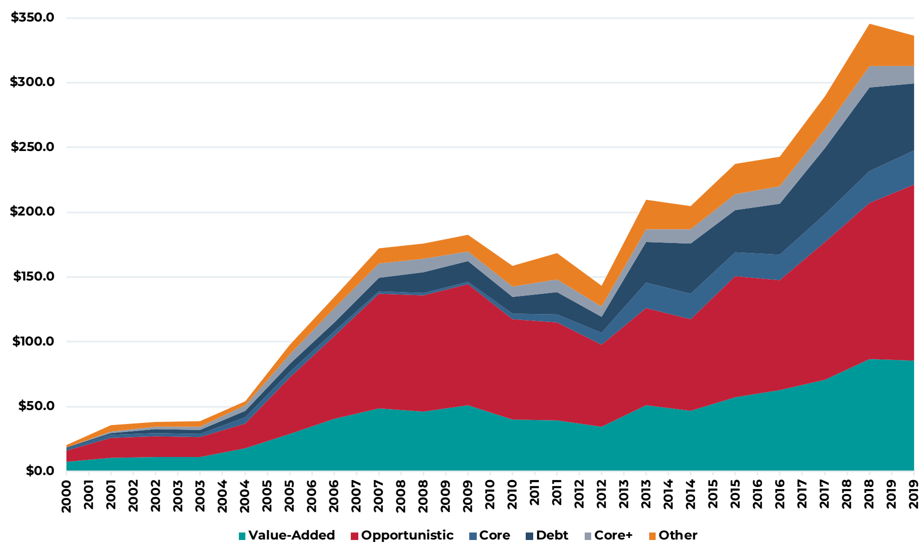


Source: Preqin

[2]Hodes-Weill/Cornell 2019 Institutional Real Estate

The pressure on prime market pricing might be limited, as much of the dry powder capital is targeting opportunistic and value-add opportunities. This capital might need to shift its focus away from traditional distressed acquisition opportunities, like non-performing loan pools. Most European and U.S. banks have by now worked out their non-core real estate loan exposures, and therefore, very few NPL opportunities remain. It is unclear whether all these well-capitalized opportunistic and value-add funds will be able to meet their high absolute return hurdles by targeting higher risk and ESG-compliant new development projects. However, assuming they are willing to do this with no or little debt, the resulting surge in new supply of space at a time of global economic slowdown, could pose some risk to core investors.

FIGURE 13
REAL ESTATE DRY POWDER CAPITAL BY STRATEGY



Source: Preqin

LOWER EXPECTED RETURNS STILL OFFER COMPELLING VALUE

GLOBAL RETURNS: FOCUS SHIFT TO INCOME

Our total return forecasts through to 2022 show areas of consistency and variation across the global investable universe. As the recovery in capital values has been strong post-G.F.C., the income component dominates our projected total returns across all three regions. We expect capital values to remain supported by a low interest rate environment, but with only pockets of further yield compression.

In the U.S., we anticipate a total return[3] of 6.1% per annum across all asset classes. In Europe and the Asia Pacific region, we forecast 5.2% per annum and 4.9% per annum, respectively. However returns within these regional averages will vary, sometimes widely.

As mentioned, income returns make up a large part of the outlook and are expected to be in a tight range of 4% to 4.5% per annum across our three regions (average across sectors).

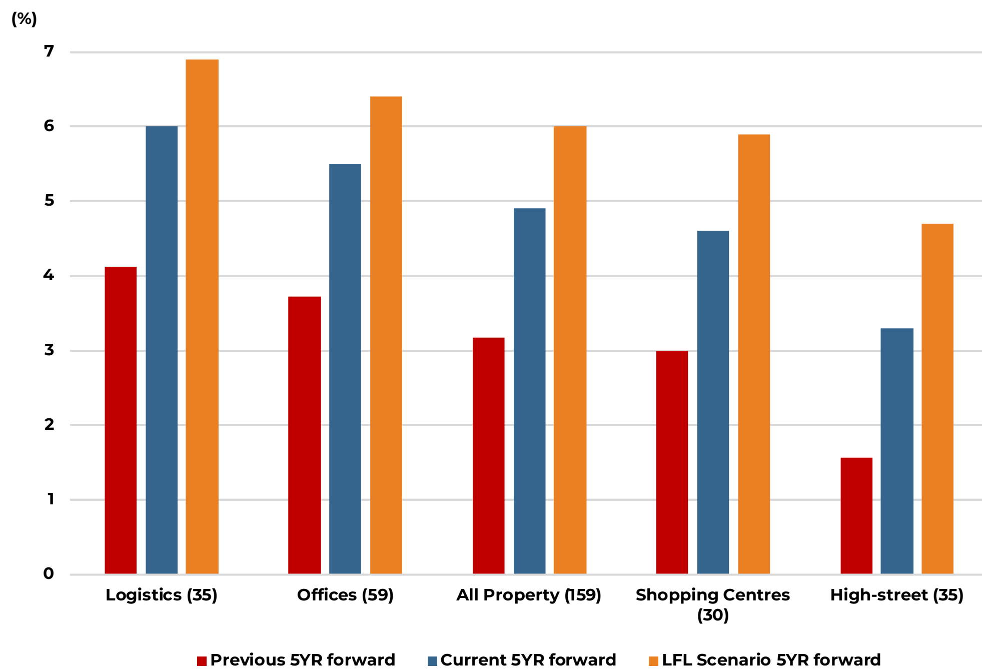
[3]Please note returns are unleveraged for the 2020 to 2022 period in local currency, our U.S. returns are for the PREA Index whereas for Europe and Asia Pacific they are for prime market

EUROPE

Market outlook has improved, making core strategies more attractive for longer. Prime European markets offer excess returns from stable income and resilient capital values as yields are expected to stay lower-for-longer. As a result, core investment strategies across European markets should offer safe and solid returns in the foreseeable future. Across the property types, we expect improved returns in both our current base case, as well as our lower-for-longer scenario compared to the previous base case.

Despite having the highest projected returns in logistics, we expect the biggest improvement compared to last year's forecasts in prime high street retail markets. Prime high street has so far been somewhat protected against the onslaught of e-commerce sales penetration, but the improvement is also due to the disproportionately large impact of recent bond yield tightening in this lowest yielding property sector.

FIGURE 14
EUROPEAN CORE EXPECTED RETURN

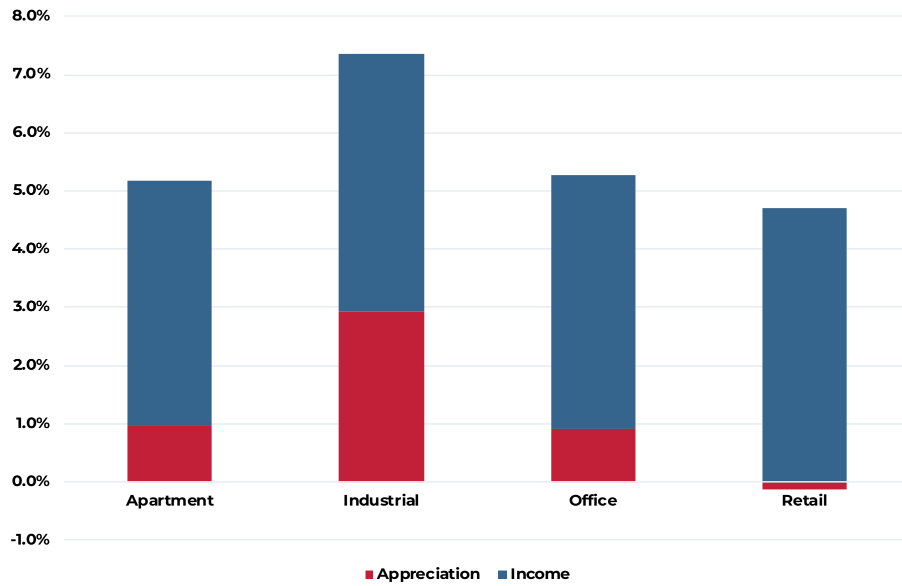


Sources: BAML, Bloomberg, RCA, REC & AEW

U.S.

Lower expected core returns lead some investors to target higher risk strategies. Nearly all of the expected return will be income, not appreciation. While competitive with other asset classes, lower expected returns are leading some investors to higher risk strategies. Industrial properties will lead the pack in core investment vehicles with total return of 7.9% over the next five years. On the other hand, retail is expected to suffer capital loss.

FIGURE 15
EXPECTED RETURN FORECAST FOR U.S.



Source: AEW Research

ASIA PACIFIC

With uncertainty a feature in the Asia Pacific region, low risk investors may want to focus new real estate buying activity on markets, sectors, and assets that have a more domestic focus, i.e. well-located assets in gateway cities in which occupiers primarily service local markets. These can continue to be high-quality, credit-worthy tenants, and can include multinational corporations that focus on local operations.

There are several different ways to access this theme during 2020 which include metro office in Australia; grocery-anchored shopping centers in pan-Asia; logistics facilities; and the residential sector in Japan.

There may also be opportunities for investors to help provide liquidity to vendors needing to sell. We continue to expect off-market opportunities to secure quality real estate assets being sold for reasons other than asset performance, i.e. China's deleveraging campaign. Also, after recent social unrest, pricing of Hong Kong assets are being adjusted down. Attractively priced assets will likely be found among office buildings outside of Central sub-markets. In the retail sector, we believe investors should look for necessity-based centers in high density residential neighborhoods.

Asia

GLYN NELSON

Head of Research, Asia Pacific
glyn.nelson@aew.com
+65 6303 9016

HANNA SAFDAR

Associate
hanna.safdar@aew.com
+65 6303 9014

Europe

HANS VRENSEN, CFA®, CRE

Head of Research, Europe
hans.vrensen@eu.aew.com
+44 (0)20 7016 4753

KEN BACCAM

Director
ken.baccam@eu.aew.com
+33 (0)1 78 40 92 66

IRÈNE FOSSÉ

Associate Director
irene.fosse@eu.aew.com
+33 (0)1 78 40 95 07

DENNIS SCHOENMAKER, PHD

Associate Director
dennis.schoenmaker@eu.aew.com
+44 (0)20 70 16 48 60

North America

MICHAEL ACTON, CFA®

Head of Research, North America
Michael.Acton@aew.com
+1 617 261 9577

RICHARD BRACE, CFA®

Director
rick.brace@aew.com
+1 617 261 9170

ADRIENNE ORTYL

Director
adrienne.ortyl@aew.com
+1 617 261 9159

RUSSELL DEVLIN, CFA®

Director
russ.devlin@aew.com
+1 617 261 9221