

BASIS OF A DEFENSIVE STRATEGY FOR INSTITUTIONAL REAL ESTATE INVESTMENT

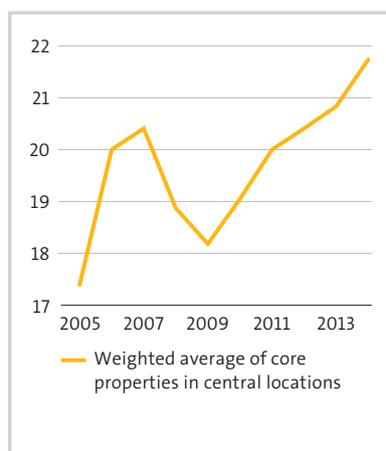
1. INTRODUCTION

There are a number of reasons why real estate is currently the focus of deliberations for institutional investors. For years the interest rate in Germany has been at historically low levels. This has an effect on all asset classes. The profit contribution from new assets in the fixed income segment has reached a historical low, while the stock markets are booming. Investors who pursue a cash flow-based investment strategy are therefore looking at physical capital assets, especially core real estate. Compared to other assets, such as bonds, core real estate offers better return opportunities in the current low interest rate phase. At the same time, certain real estate investments appear to be much less prone to setbacks in market correction phases than shares or stock indices.

In Germany and Europe the investment pressure of domestic and foreign investors meets a limited supply of real estate, with the result that prices continue to rise. This applies both for commercial and residential real estate. Cheap loan capital sourcing also contributes to the price increase. In this market boom phase there is an urgent need for defensively-oriented institutional investors to have the right investment strategy.

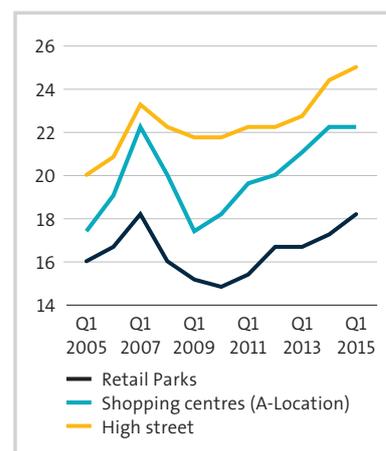
If we consider the purchase factors for office and retail real estate alongside the purchase price development of apartments, it can be seen that the level in 2015 is at least the same or clearly above the 2007 level.

OFFICE PURCHASE FACTORS (NET) IN THE TOP 7 CITIES



Source: bulwiengesa/KGAL

RETAIL PURCHASE FACTORS (NET) IN GERMANY



Source: CBRE/KGAL

OWNER-OCCUPIED APARTMENT PRICE DEVELOPMENT IN GERMANY



Source: empirica/KGAL

Compared to other real estate classes, residential real estate in top locations generally features the lowest risks, but generally achieves lower returns than commercial real estate. For a defensive real estate strategy, residential real estate is thus suitable, though with the disadvantage of a relatively lower ongoing return. The focus of this document is whether, or which, commercial real estate properties have a comparably low risk with solid earnings prospects.

2. DEFENSIVE REAL ESTATE INVESTMENTS: OPTIONS FOR ACTION

Prime locations in top cities remain a good opportunity to invest in commercial real estate in the long term with low risk. However, in light of high purchase prices it is becoming increasingly difficult to achieve stable returns of between three and five percent. A closer assessment and differentiation of the various commercial real estate classes, particularly with regard to future market corrections or economic fluctuations, paints the following picture:

1. **Retail real estate in top locations** have relatively robust cash flows with low volatility, even during periods of market correction or economic weakness. Due to high price levels the initial yield is very low. In top locations, such as Munich's Kaufinger Straße or Frankfurt's Zeil boulevard, it has been well below five percent for years.
2. Due to the market situation, **core office real estate** is also currently achieving relatively low cash flow. These assets are also proving themselves to be dependent on economic trends, and thus more vulnerable to vacancies during economic downturns, even if they are in good locations but not in one of the top addresses in A-cities.
3. **Mixed-use commercial real estate in high frequency locations**, such as mixed-use district centres as well as retail parks, can have a low risk profile and robust cash flows with the right property selection. A concentration of the tenant mix on basic supply (i.e. goods and services which are needed daily or periodically) makes these properties largely immune to economic cycles, and achieves stable returns.

The combination outlined above, with stable cash flows and independence from the economic cycle, makes mixed-use district centres and retail parks attractive and relatively secure alternatives to commercial real estate in top locations or residential real estate. A special characteristic is that they move away from the standard location classification and must be considered on a case-by-case basis. Nevertheless there are clear criteria, which are discussed hereafter.

MIXED-USE DISTRICT
CENTRES AND RETAIL PARKS
PROVE TO BE ATTRACTIVE
AND RELATIVELY SECURE
ALTERNATIVES

3. BASIS OF A DEFENSIVE REAL ESTATE STRATEGY

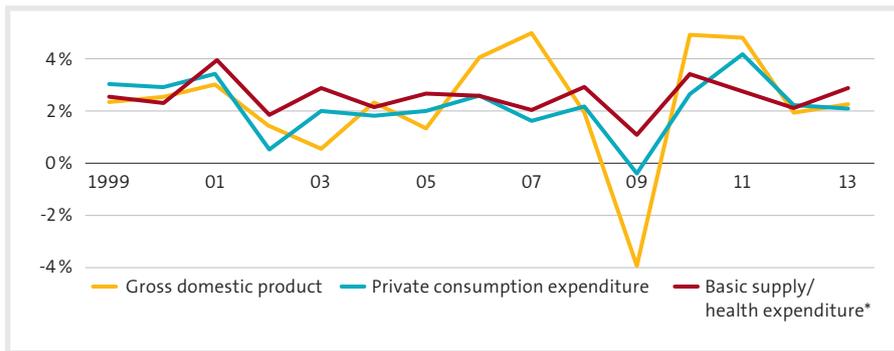
A property with a defensive character remains relatively stable in economic downturns, and maintains its attractiveness in the long term. Mixed-use district centres and retail parks fulfil these criteria. In addition to the already mentioned concentration on basic supply (goods and services) there are also other factors which ensure the future viability of these real estate types.

3.1 BASIC SUPPLY IS INDEPENDENT OF THE ECONOMIC CYCLE

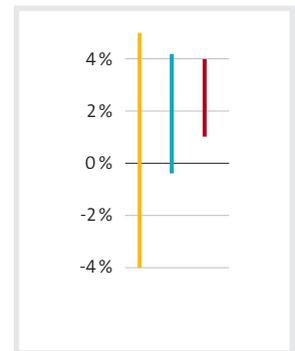
Goods which are needed daily or periodically are much less dependent on economic cycles than other private consumption expenditure. In simple terms: Food, drug store items, and health and social services are always in demand.

Data from the Federal Statistical Office (see following graphic) demonstrates the economic cycle independence of basic supply. They show that in the last 15 years, expenditure for basic supply grew by an average of more than two percent per year, with a low fluctuation margin of under three percentage points. In contrast, private consumer spending and gross domestic product (GDP) was much more volatile. Particularly interesting are the numbers from 2009, when the German economy fell significantly as a result of the global financial and economic crisis. While the GDP dropped by 4 percent and private consumption expenditure sank by 0.4 percent compared to the previous year, the expenditure for basic supply grew by approx. 1 percent.

COMPARISON OF GDP, PRIVATE CONSUMPTION AND BASIC SUPPLY/ HEALTH EXPENDITURE (IN % COMP. PREVIOUS YEAR)



VARIATION OF THE CHANGES IN % (1999 – 2013)



Source: Federal Statistical Office / Federal Health Reporting (GBE) / KGAL

* Food, beverages, home, water, electricity, combustibles, tobacco products, health care, education, personal hygiene, social services, medical services, prevention/health protection, nursing care/therapeutic services, other services and other

Tenants which cover basic supply, such as grocery stores, drug stores, chemists, administrative bodies/public authorities, doctors etc., thus also represent a lower risk of rental losses in economic downturns.

3.2 FUTURE VIABILITY

The future viability of retail and basic supply real estate is determined by various factors:

- Location/visitor frequency
- Property size
- Tenant structure
- Strategic positioning compared to online commerce

LOCATION AND VISITOR FREQUENCY

For retail the location is vitally important. However for mixed-use district centres and retail parks this is not always synonymous with A or B locations. What counts here is an established level of visitor frequency. Very good locations are synonymous with a high degree of familiarity and dominant position in the area. For mixed-use district centres these locations are in the neighbourhood centres of A cities and the centre of B cities, and for retail parks they are easily accessible traffic locations outside the city. They are centres which, in the best case scenario, have been offering retail and supplies for decades, and are known as “learned” locations. These guarantee high visitor frequency. With the appropriate catchment area an interesting property can also be an established local mixed-use district centre or retail park in greenfield locations outside the city

A “LEARNED” LOCATION ENSURES ACCEPTANCE

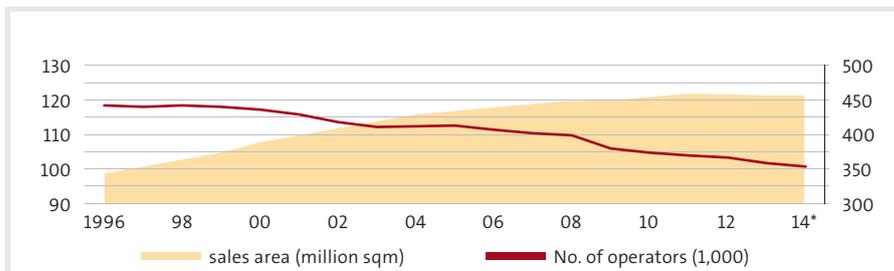
The location and tenant mix (mutual reinforcement, e.g. doctors and chemists, retail and administrative bodies) ensure a high visitor frequency. High visitor frequency correlates with stable revenue. That is why good private and public transport connections, plus town planning objectives and future development, are important for such locations.

PROPERTY SIZE

Mixed-use district centres and retail parks must have a critical size in order to develop a sufficient pull effect on their target clientele. More area is synonymous with a wider tenant mix and an extensive range of offers – both attractive factors for a constant, high flow of visitors.

The following diagram documents how important additional area is to retail. It shows two opposing developments: on the one hand a clear increase in the total selling space in Germany since the middle of the 90s, from 99 million sqm to over 120 million sqm in 2014, and on the other hand a decrease in the total number of retail operations, from 445,000 to approx. 355,000.

DEVELOPMENT TOTAL SELLING SPACE AND NUMBER OF RETAILERS IN GERMANY

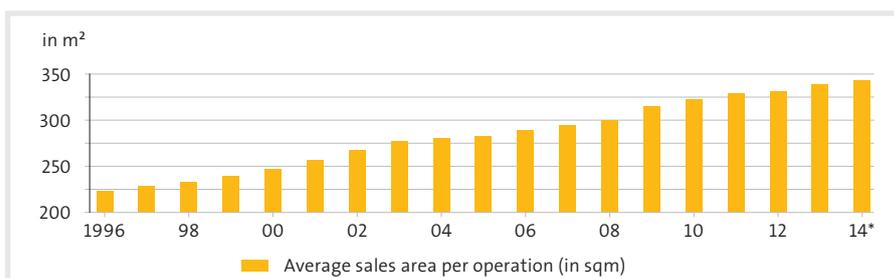


Source: Dr. Lademann & Partner/CBRE/KGAL

* Forecast

A decrease in retailers at the same time as the total selling space increased equates to a clear increase in the average shop size per retailer. The following graph documents this.

DEVELOPMENT OF THE AVERAGE AREA PER RETAILER



Source: Dr. Lademann & Partner/CBRE/KGAL

* Forecast

The reason for steady expansion of retailer area is that customers prefer businesses with a larger product selection. For the retailers, on the other hand, a larger area makes it possible to optimise their costs. A flexible concept, which makes structural modifications easier and provides for optional expansion, also makes change of tenants easier.

Future-proof mixed-use district centres must take this development into account. For retail, the larger the sales area, the more significant is the dominance. A large mixed-use district centre with an extensive range of offers, high level of recognition and a central, highly frequented location develops a pull effect on both visitors and future tenants. At the same time, these central locations with very good transport connections, whether they are found in the centre of town, in the neighbourhoods, in a convenient location on the outskirts, or outside the city, are difficult to reproduce and offer relatively high protection against competition. This is often also due to approval restrictions by the local authorities. A large mixed-use district centre, for example on the market square of a small town, covers the basic supply needs of the urban population. The danger of current or future competition is relatively low.

DOMINANCE IN THE MARKET SECURES LONG-TERM COMPETITIVENESS

TENANT STRUCTURE AND DIVERSIFICATION

The tenant and branch mix is an important requirement to ensure the sustainability and stability of mixed-use district centres and retail parks. A wide range of basic supply offers, retail, and personal services such as health facilities, creates a location where many needs can be met. Asset management through new leases and re-lettings is very important. It creates the conditions for sustainable attractiveness of the property.

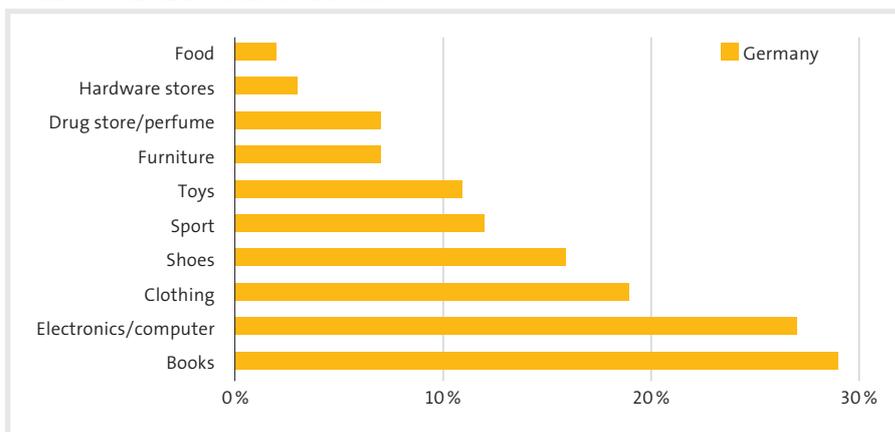
BASIC SUPPLY AND SERVICES CREATE STABILITY

STRATEGIC POSITIONING COMPARED TO E-COMMERCE

In certain branches online commerce has gained a large market share. The least affected is basic supply. According to Regio Plan 2014, in Germany only approx. 2 percent of food, 3 percent of hardware items and 7 percent of drug store/perfume items are ordered online.

PRODUCTS FOR DAILY NEEDS AND PERSONAL SERVICES APPEAR ROBUST IN THE FACE OF E-COMMERCE

SHARE OF ONLINE BUSINESS BY BRANCH

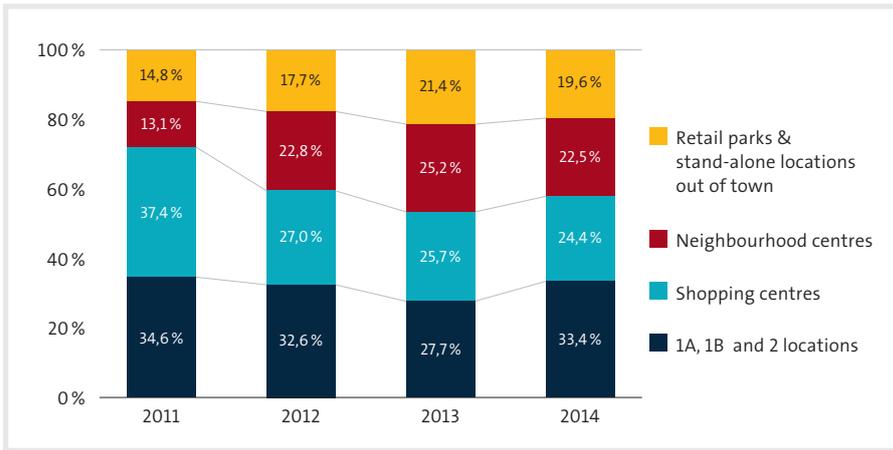


Source: Regio Plan 2014

A tenant mix which focuses on basic supply and services is likely to face a low level of competition from online businesses.

This makes further development interesting. A comparison of rental performance in retail shows that mixed-use district centres and retail parks have increased in appeal for retailers in recent years. Their total combined share of new leases increased from 27.9 percent in 2011 to 42.1 percent in 2014.

DISTRIBUTION OF NEW LETTINGS (RETAIL)



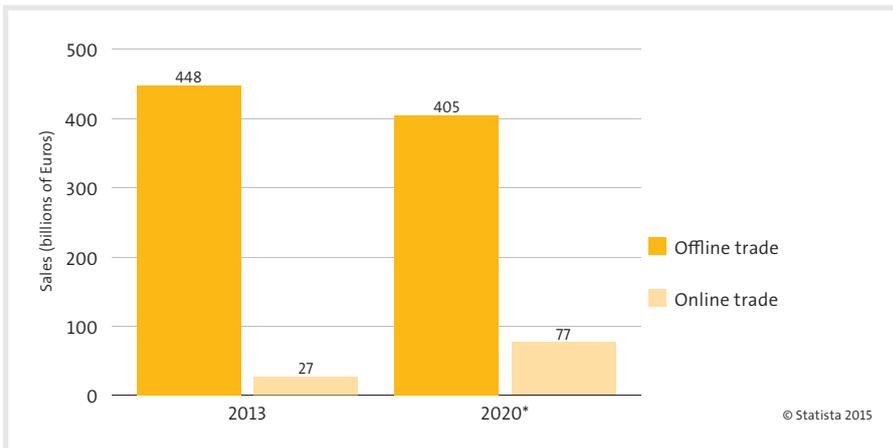
Source: CBRE

The graphic above shows that neighbourhood market centres and retail parks are now more attractive to retailers than shopping centres. One reason is most likely that the rents are relatively cheaper. It is reasonable to expect that the relatively lower rents in the mixed-use district centres and particularly in retail parks make these locations more competitive and attractive than e-commerce, with its high return costs.

SIZE, HIGH FREQUENCY
AND LOW RENTS SECURE
RETAIL ON LOCATION

In this context there is the basic question of how distribution of sales will develop between online and physical trading in the future. The Institute for Commercial Research (Institut für Handelsforschung) predicts that physical trading will continue to lose market share. It expects a loss of turnover of around ten percent by the year 2020, as shown in the following graphic.

TURNOVER IN ONLINE AND STATIONARY TRADING IN GERMANY IN THE YEAR 2013 AND FORECAST FOR 2020 (IN BILLION EURO)



Source: IfH Köln

© Statista 2015

* Forecast

On the other hand, the future competitive situation of retailers who offer basic supply goods seems viable in light of the graphic on page 05 (share of online trade by branch).

4. CONCLUSIONS

The financial markets crisis and the current market boom in the real estate sector create a challenging environment for defensive investment strategies. Core real estate, the classic “safe haven“ for low-risk investments, are currently valued so high that these assets only achieve low returns.

A defensive real estate strategy, with a focus on security and stable ongoing returns, can find attractive investment objectives in basic supply locations, which are largely independent of economic cycles, or appropriately focused retail real estate. However, the categorisation of such mixed-use district centres requires a new definition regarding location.

A simple prioritisation according to A, B and C locations is not adequate. Much more relevant is the stability of the turnover achieved and individual location considerations. Against this backdrop, the focus is moving towards urban districts and high-frequency locations on the outskirts, which have a very favourable risk-return profile compared to retail in top locations. Decisive in this case are good public transport connections or strategic positioning on important transport hubs and roads, combined with a market-dominating size and prominence in the local sub-market.

This combination of basic supply, dominance in the sub-market, and future viability creates a solid base for robust, sustainable cash flows across all economic cycles.

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