



What is Real Estate?


Diversification

Categories

How to Invest...

A Guide to Real Estate

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Introduction

The introduction of Modern Portfolio Theory by Harry Markowitz in the 1950s advocated an allocation to alternative investment classes, including real estate, to increase return for a given level of risk. The widespread acceptance of Markowitz's proposition amongst both the academic community and institutional investors has cemented real estate as a bona fide asset class.

The experience of the last 40 years indicates that an allocation to real estate can benefit portfolios both from a return and diversification perspective. As rental values tend to move in line with inflation, real estate can also protect in real terms against rising prices. Commercial real estate in particular has demonstrated little or no relationship to the stock market*.

Prior to the 1990s, investment in real estate was largely dominated by institutional investors including pension funds and life companies. However, progress has been made in making the asset class more accessible to a wider group of investors with the launch of real estate funds and listed real estate vehicles such as real estate investment trusts (REITs). Like most investments, real estate has its benefits but also its drawbacks, primarily in the form of high minimum investments, liquidity and high costs. Therefore, the means through which an investor gains exposure to the asset class needs to be considered carefully.

This guide will take you through these and other relevant topics in more detail, explaining what real estate is and how it differs from investing in other more traditional asset classes, why an investor might invest in real estate and what the limitations might be. I hope you find the guide useful in considering your investment options.



Michael MacGrath

Senior Investment Analyst - Alternative Assets

Global Investment Selection

*Source: *The Performance of Real Estate as an Asset Class*, William N. Goetzmann and Roger G. Ibbotson, 1990

01

Real Estate as an Asset Class



Real Estate as an Asset Class

- Real estate is a diverse asset class which consists of three main sub-classes:

 Commercial	 Residential	 Land/Development
Retail	Principal private residence	Brown field
Office	Vacation homes	Green field
Industrial	Condominiums	
Multifamily	Duplexes	
Other (including Hotels and Healthcare)		

- Real estate returns can come in the form of income and/or capital appreciation.
- Typically, core real estate focuses more on the delivery of strong cash flows (or yield) with some capital appreciation over the long term, whereas opportunistic* real estate investing, including development, tends to focus more on capital appreciation.

“While real estate markets sometimes produce dramatically cyclical returns, pricing inefficiencies in the asset class and opportunities to add value allow superior managers to generate excess returns over long time horizons... A steady flow of income with equity upside creates a natural hedge against unanticipated inflation without a sacrifice of expected return.” **The Yale Endowment: 2013 Annual Report**

*See page 19 for explanation of opportunistic

Factors to Consider when Selecting Real Estate Investments

Property type	Real estate can be income-producing or non-income producing. There are four broad types of income-producing real estate: offices, retail, industrial and leased residential.
Location	Location, Location, Location! Prime, secondary and tertiary locations are used to describe the quality of the property's location. As quality differs, so do rents, with prime locations commanding higher rents per square metre than secondary locations (a London office property will demand a higher rent than its equivalent in Birmingham or Manchester Central Business Districts). Properties in tertiary locations are likely to experience the biggest swings in value over a longer period of time, while properties in prime and secondary locations will likely have a head start during the up-cycle in the race for appreciation.
Tenant quality	A real estate asset may be valued as the present day value of future cash flows arising from lease contracts, which are in turn valued by the quality business growth and financial stability of the tenants.
Occupancy	Occupancy rate is the percentage of the building that is leased. This is important as it provides an indication of anticipated future cash flows.
Leverage	Investing borrowed capital has the potential to amplify the returns experienced by the investor.
Yield	Yield is the return from investing in real estate. This is typically measured as the current rental income divided by the market value of the property. Demand for property drives property valuations up and thus affects the yield. As property prices rise, rent represents a smaller percentage of property value. This is referred to as yield 'hardening'. Conversely, property values falling can cause yields to 'soften'.
Reversionary yield	Reversionary yield is the anticipated yield to which the current yield will rise (or fall) if the lease on the property were rented at prevailing market rental rates (which may differ from the rent being charged under the lease).
Acquisition/Disposal costs	When compared with other asset classes, investment in property can be quite costly. Stamp duty, maintenance fees, borrowing costs, solicitors' fees, auctioneers' fees and capital gains tax all play a part in reducing overall net returns. These typically translate into high once-off upfront costs on acquisition and high selling costs on disposal.

A large, stylized graphic of the number '02' in a light blue color, positioned on the left side of the slide. The '0' is a thick, rounded shape, and the '2' is a thick, curved shape that fits into the bottom of the '0'.

02

Why Invest in Real Estate?

“The 20-year track record of this asset class shows that real estate has earned its way into a diversified portfolio.”

Hudson-Wilson, Gordon, Fabozzi, Anson and Gilberto:
“Why Real Estate?”, Journal of Portfolio Management, Special Issue 2005

Why Invest in Real Estate?

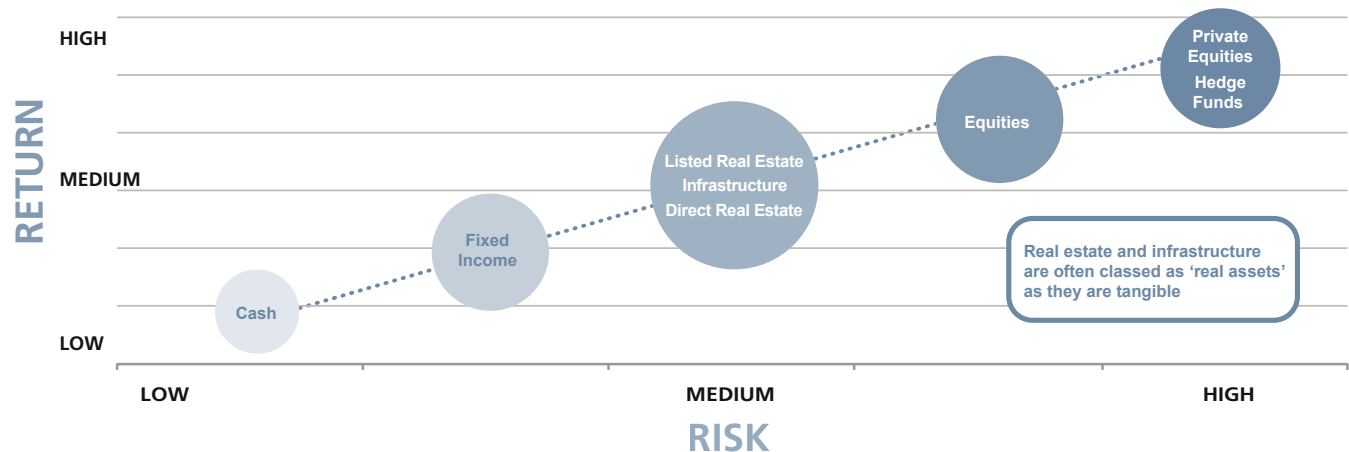
Real estate may reduce the overall risk of the portfolio through **diversification**.

Through the market cycle, real estate is capable of achieving an absolute return competitive with other asset classes. As an asset class, it can provide **favourable returns** in the form of:

- Enhanced portfolio income
- Capital appreciation

Real estate assets have an intrinsic value. They are valued for their direct or indirect usefulness. Real estate rents and values tend to rise as prices do. This makes real estate a **natural inflation hedge**, as the real value of the underlying asset is protected.

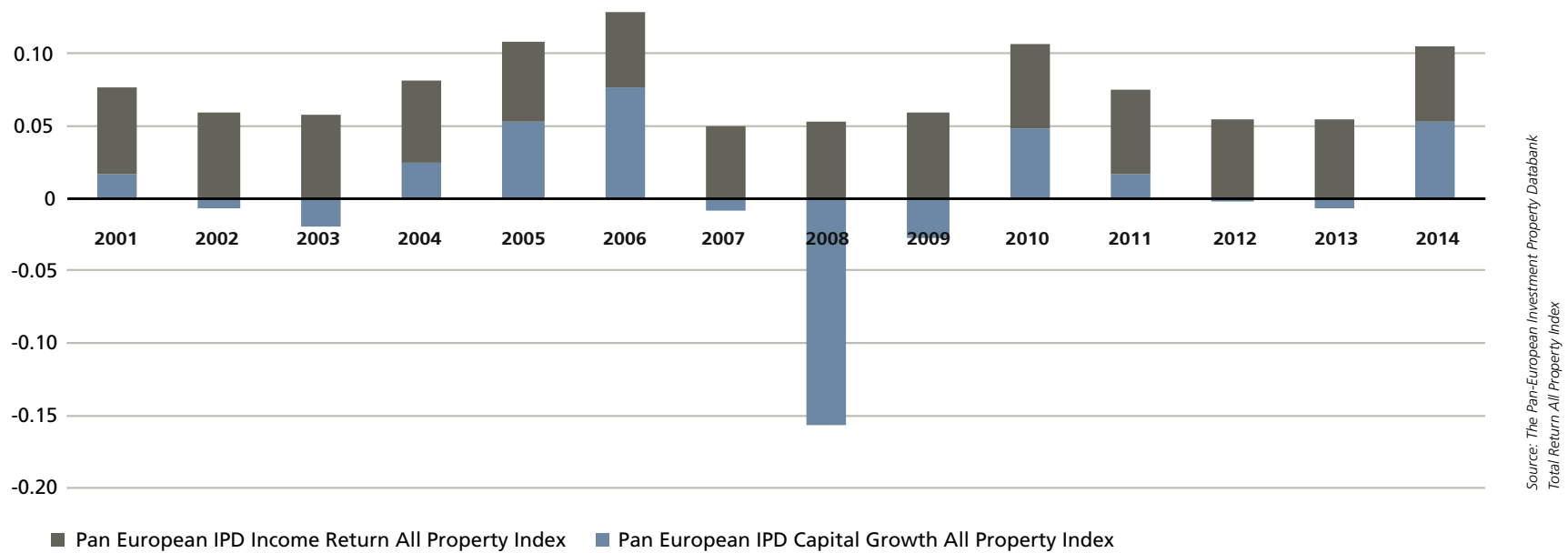
Figure 1: Real estate ranks between fixed income and equities on the risk/return scale



Source: AMP Capital.
 For illustrative purposes only.

Performance

Figure 2: Performance of European real estate, 2001-2014



Source: The Pan-European Investment Property Databank Total Return All Property Index

Since 2001, real estate in Europe has returned on average 6.9%* annually. The return profile for opportunistic funds will typically target higher returns than those for prime real estate funds. This is reflective of the additional risk associated with opportunistic funds. Opportunistic investing typically targets higher risk strategies such as real estate development, highly leveraged financing or transactions involving 'turnaround' potential (distressed investing).

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up.

*The Pan-European Investment Property Databank Total Return All Property Index

“The experience of the last 40 years indicates that housing prices move up when stock prices move down, and vice-versa, while commercial real estate has little or no relationship to the stock market. Both of these are good news for institutional investors seeking to hedge against inflation and fluctuations in the financial markets. Increases in interest rates also influence real estate returns, driving housing values lower and commercial real estate returns higher.”

William N. Goetzmann and Roger C. Ibbotson:
“The Performance of Real Estate as an Asset Class”
1990

Inflation Protection

Real estate is one of the few asset classes that reacts broadly in line with inflation:

- Real estate as a tangible asset holds an intrinsic value - not only does the structure have value but so too does the land it is situated on.
- Rental contracts are typically indexed to inflation so rental income should also keep pace with inflation.
- Rental agreements for commercial properties may be linked to the consumer price index.



Diversification - The Endowment Model

The nature of real estate provides diversification within the asset class. Each sub-category of real estate has its own underlying economic drivers that affect valuation:

1. **Office values are affected by employment growth**
2. **Changes in levels of business and leisure travel affects the success of hotels**
3. **Consumer spending influences the value of retail properties**
4. **Demographics have a knock-on effect on residential property**

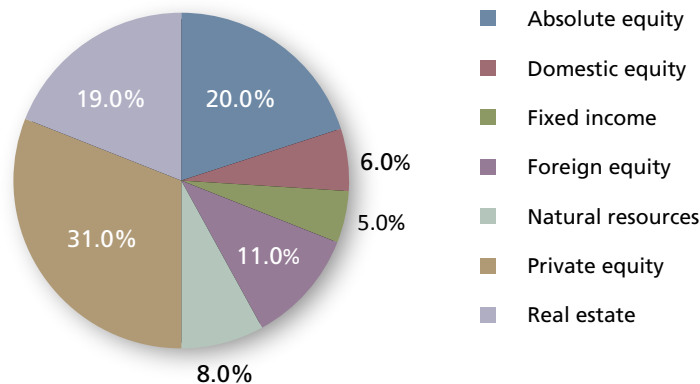
“Studies show that the inclusion of international real estate in a multi-asset portfolio leads to a decrease in portfolio risk at every level of expected return.”

Adrian Chua:

“The Role of International Real Estate in the Global Mixed-Asset Investment Portfolios, Vol. 5, No.2 pp. 129-137” 1999

Figure 3: Yale asset allocation target (as at 30th June 2013)

Yale was an early advocate of alternative assets and in June 2013 had a target allocation of 19% of its endowment portfolio to real estate.



Source: The Yale Endowment, 2013 Annual Report

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Categories of Real Estate



A Focus on Commercial Real Estate

The value of commercial real estate globally totalled €2.3 trillion in 2013, representing a significant proportion of the total wealth in the economy*. When investing in commercial real estate, there are a number of factors that will determine yield and valuation:

1. **Location, Location, Location!:** prime properties will typically attract higher rents than those in secondary locations. In March 2015, London West End retail properties commanded a rent of £1300.00 per ITZA per annum, whereas properties in Birmingham commanded a much lower rent of £300.00 per ITZA per annum**.
2. **The Lease:** the more certain the future cash flows, the less risk associated with the property. A property with a good quality tenant (high credit rating), a longer unexpired lease term and a high occupancy rate provides more certainty to the investor that rents will be paid. Investors should consider the reversionary yield for properties with upcoming lease breaks or maturities.
3. **The Yield:** the yield is made up of two components: 1) current rents and 2) market value of the property.
 - A. As rents increase, so too will the yield.
 - B. However, as market values increase the yield will decrease. Therefore, the yield will be influenced both by the ability to achieve a good rental income and changing property valuations.
 - C. Typically, the higher the yield, the greater the risk associated with the property.
 - D. Supply and demand factors will also affect the yield. If there is a high supply of properties or if there is greater demand for properties (driven by increasing employment levels, consumer spending, economic growth), it may impact market rents and market valuations.

*Peng (2014) – How is Leverage Determined for Commercial Real Estate?, Leeds University Business School, pp. 2

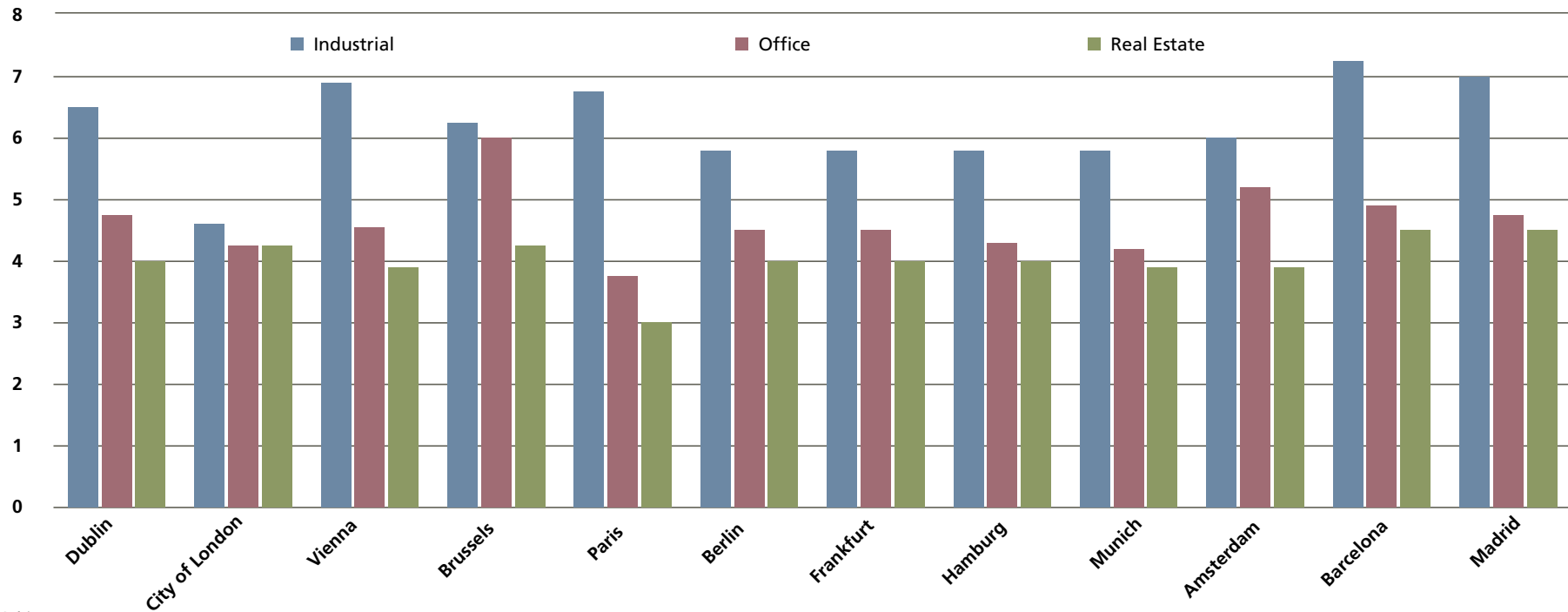
** ITZA = In Terms of Zone A, a shop premises valuation method. Source: CBRE Market Review, EMEA Rents and Yields, Q1 2015

A Focus on Commercial Real Estate

There are a number of different classes of commercial real estate, for example:

- **Retail space** can be valued in relation to consumer spending; the nearer the high street, the more prime the location.
- The quality of **office space** depends less on being located on the high street and more on the quality of the building, the access to transport and prevailing employment levels.
- The value of **logistics space** is related to the economic cycle and the production levels in the economy. It can be assessed using gross domestic product as a proxy.

Figure 4: European cities' prime rental yields (%)



Source: CBRE Market View, EMEA Rents and Yields, Q1 2015

A Focus on Residential Real Estate

While the majority of residential property in developed markets is owner-occupied, the start of the 21st century has seen a growing trend for institutional residential investment. This has largely come in the form of companies acquiring and managing significant numbers of residential properties. This helps investors diversify away from a single property concentrated investment as well as benefiting from economies of scale and management efficiencies that can emerge through ownership of a large number of residential properties.

Examples:

- Invitation Homes, formed by Blackstone in 2012, has 46,000 properties and is now the largest landlord of family houses in the US.
- In Germany, there are a number of residential property companies. Deutsche Annington currently owns around 200,000 leased and managed apartments and Deutsche Wohnen's portfolio includes almost 147,000 residential units.
- In Ireland, we have also seen an institutional residential property market beginning to emerge. Kennedy Wilson Europe Real Estate Plc has 25% of its portfolio located in Ireland.

While residential property has similar characteristics to commercial real estate, there are some key differences:

1. **Length of lease:** residential tenants are typically committed to relatively short renewable leases of 12 months or less.
2. **Tenant quality:** while prime commercial real estate will typically have investment-grade type tenants, residential tenants will be individuals.
3. **Liability of tenants:** landlords of residential property are usually responsible for repairs, whereas tenants of commercial property usually remain responsible for repairs.

Source: 'Blackstone Hires Ares Partner Bartling as Invitation CEO', Bloomberg, October 2014; Deutsche Annington, June 2014; Press Release, GAGFAH, June 2015, Q1 2015, Investor Presentation, Kennedy Wilson

A Focus on Land/Development

Types of Land Investment	
Brown Field Investment	A piece of industrial or commercial property that is abandoned or underused and often environmentally contaminated, especially one considered as a potential site for redevelopment.
Green Field Investment	Land that is undeveloped in a city or rural area either used for agriculture, landscape design, or left to evolve naturally. These areas of land are usually agricultural or amenity properties being considered for urban development.

Stages of Land Investment

- Developing land is both the most lucrative and most difficult form of property investment. When investing in land, it can either be sold without development or at any of the following intermediate stages:



- As a tangible asset, more control is placed in the hands of the development team. Land has tended to appreciate much faster than developed properties in a rising market (and falls faster in a falling market) so good timing is essential for maximum profitability. Capital appreciation is more often than not the only source of investment return as investing in land rarely provides yield.

A Focus on Listed Real Estate (including REITs)

A real estate investment trust (REIT) is a listed company which is used to hold rental investment property. REITs are required to distribute the vast majority of their profits to investors each year. REITs do not necessarily trade at their true Net Asset Value (NAV). REITs often trade at a discount or premium to their NAV due to investor sentiment towards the fund. European REITs typically have had a bias towards retail and residential properties, with minimal exposure to office and logistical properties.

In Table 1, REITs have a higher correlation (0.8) to equities than to direct real estate assets (0.4). This means the movement in pricing of REITs displays more similarities to the stock market than to direct investment in property. Therefore REITs do not provide the same level of diversification as investing in direct property or a property fund.

Table 1: Correlation of price changes (all indices in local currency)*

	MSCI World (equities)	10-year US Government Bonds (fixed Income)	Global REITs/ Real Estate Equities	Direct investment in Office Real Estate, Global
MSCI World (equities)	1.0			
10-year US Government Bonds (fixed Income)	-0.6	1.0		
Global REITs/Real Estate Equities	0.8	-0.3	1.0	
Direct investment in Office Real Estate, Global	0.3	-0.2	0.4	1.0

Source: PMA, Datastream, 'Real Estate as an Asset Class', Credit Suisse

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. These products may be affected by changes in currency exchange rates.

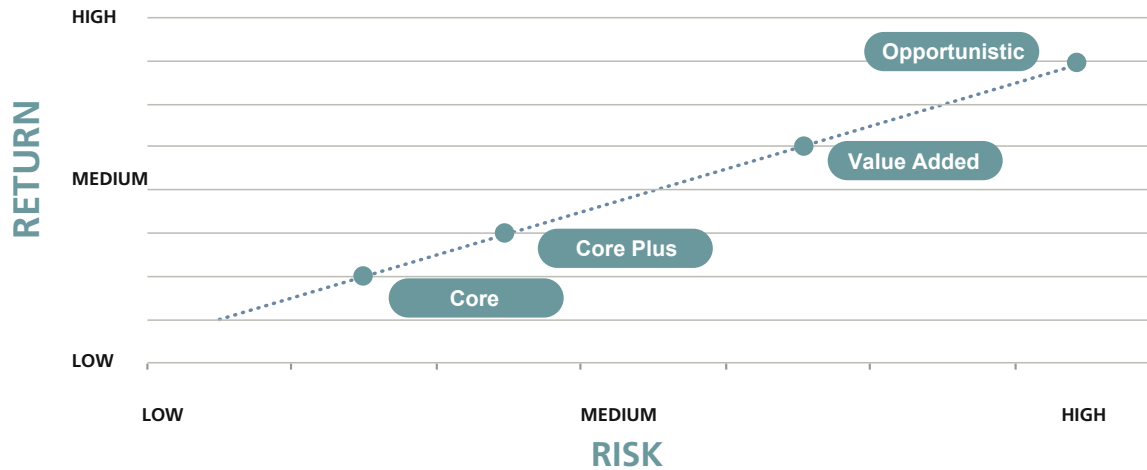
*All indices are price indices. Calculated on the basis of price indices for quarterly figures, starting from 31st December 2000. Direct investment is based on Credit Suisse aggregation, based on PMA cash values for the world's leading cities; weighted using GDP and liquidity ratios. Last data point: June 2014.

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How to Invest in Real Estate

Different Investment Styles

Figure 5: Different investment styles



<p>Core</p> <p>High quality properties at good locations, generally with existing long-term leases. Returns are mainly generated by the rental income component although total returns can vary over time.</p>	<p>Core Plus</p> <p>Similar to the core investment style but leases tend to be shorter, properties less central and there may be a higher level of borrowing.</p>
<p>Value Added</p> <p>Both income and value enhancement play a role including renovations, new leases and non-speculative project development. Loan-to-value ratio is typically between 40% and 60%*.</p>	<p>Opportunistic</p> <p>Highly speculative strategy. Loan-to-value ratio is typically above 70%*.</p>

*Source: 'Real Estate as an Asset Class', 2014, Credit Suisse.

How to Invest in Real Estate

Description	Benefits	Risks
Direct – acquiring a real property asset directly	<ul style="list-style-type: none"> • Real exposure to property • No fund management fees • Investor has full control of the asset 	<ul style="list-style-type: none"> • Concentration in a single asset reduces diversification benefit • High minimum investment • Very illiquid • Investor must manage the asset and bear all costs
Real estate funds	<ul style="list-style-type: none"> • Real exposure to a diversified portfolio of properties • More liquid than acquiring assets directly, typically quarterly • Lower minimum investment size • Fund manages the asset 	<ul style="list-style-type: none"> • Fund management fees • No control of underlying asset acquisitions or disposals • Liquidity may be suspended during times of market distress
Real estate debt funds	<ul style="list-style-type: none"> • Liquid • Lower minimum investment size • Fund manages the asset 	<ul style="list-style-type: none"> • Fund management fees • Can be more correlated to fixed income than real estate, thereby reducing diversification benefits • May not provide the same inflation protection • No control of underlying debt asset acquisitions or disposals
REITs/Listed real estate companies	<ul style="list-style-type: none"> • Liquid • Low minimum investment size • Management company manages the assets 	<ul style="list-style-type: none"> • Low correlation to real estate in short and medium term, thereby reducing the diversification benefits • Can trade at significant discounts or premiums to NAV • Difficult to get diversified exposure across real estate asset classes • Management fees typically apply

Warning: Please note the comparison above is neither comprehensive nor exhaustive. It has been provided for discussion purposes only.



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Summary

A Recap on Real Estate

- Real estate is an important part of any multi-asset portfolio and can provide diversification, inflation protection and yield.
- The level of expected returns can vary depending on the level of risk employed. Core funds are typically regarded as the “safest” within the asset class with opportunistic (including land and development) being the highest risk.
- When investing in commercial real estate, location, lease quality and supply and demand will affect the expected yield and valuation of the property.
- There is a growing interest in investing in large portfolios of residential real estate assets. When investing in this asset class, diversification is essential.
- REITs, although a more liquid and accessible option, do not necessarily provide true exposure to property in the short to medium term as they can display a significant amount of correlation with equity markets.
- The main drawbacks to investing in real estate are:
 - Liquidity
 - High minimum investment sizes
 - High acquisition and disposal costs



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