Investment Team Update

10 August 2017

Property Markets: The Quarter in Review

PERSPECTIVE FROM FRANKLIN REAL ASSET ADVISORS®

With global property markets in different stages of the real estate cycle, various economic forces are impacting regions and sectors in distinct ways.

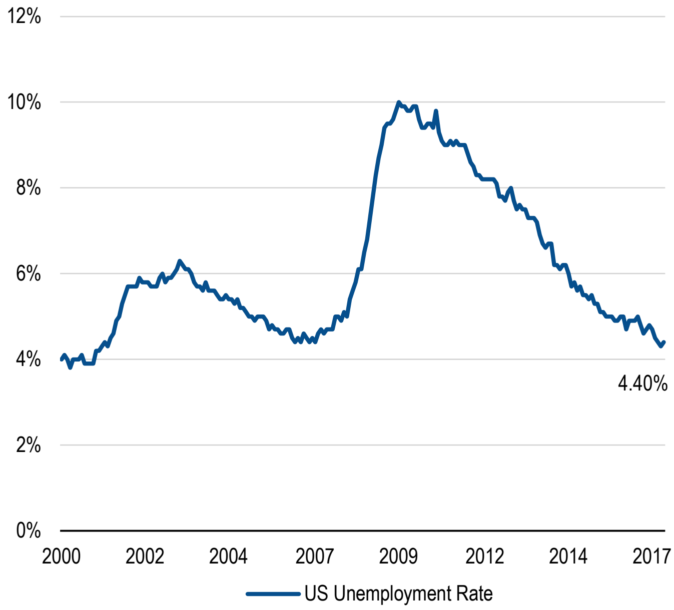
In this market review, Franklin Real Asset Advisors explores the macroeconomic environment and notable real estate sectors in the United States, Europe and Asia over the second quarter of 2017, identifying where they see opportunities across the landscape.

US Property Markets

- The US Federal Reserve raised short-term interest rates in the second quarter of 2017 by an additional 25 basis points and signaled the likelihood of additional increases before the end of the year.
- New supply has been entering the multifamily sector resulting in increasing vacancy rates during the quarter.
- Despite increases in overall vacancy rates in the office property sector, due to new supply coming online, technology related tenants continue to drive demand and net absorption remained positive for the 29th consecutive quarter.
- Retail construction and development slowed over the quarter as the sector struggles to evolve to match changing tastes and compete with online retail options.

During the quarter, the US Federal Reserve (Fed) increased short-term interest rates by 25 basis points (bps) from 1.00% to 1.25% noting that an additional increase is likely to occur by December.[1] The Fed has targeted an inflation rate of 2.0% and seeks to foster maximum employment to justify future increases. During June, nonfarm payroll increased by 222,000 with the unemployment rate dropping by one tenth of one percent to 4.4%, demonstrating a strengthening economy.[2] Infrastructure spending and potential tax reform continue to fuel economic tailwinds while tariffs on imports into the United States as well as geopolitical tensions around the globe provide

Chart 1: US Unemployment Continues to Decline
January 2000–June 2017



Source: FactSet, US Department of Labor. Important data provider notices and terms available at www.franklintempletondatasources.com. The above chart is for illustrative and discussion purposes only.

potential headwinds. On balance, the US economy is poised for modest growth with gross domestic product (GDP) for the year forecast at just over 2%, subject to unforeseen changes regarding pacing of short-term interest-rate increases, inflation and increasing geopolitical conflicts.[3]

As at May 2017, investment activity continued to slow, decreasing by 12% year-over-year (yoy).[4] The largest driver for this decrease is largely attributable to the deceleration of transactions in the multifamily sector which is not unexpected due to the multi-year delivery of new supply into select markets. As a result, transaction volume in the multifamily sector is down 25% yoy and for office down by 5% yoy.[4] The bright spot in transaction volume lies with hotel and industrial, posting growth of more than 20% yoy.[4] Due to the mature stage of most major commercial real estate markets in the United States, a slowdown in transaction volume is healthy, demonstrating a market seeking stability.

Decreases in transaction volume, coupled with increases in vacancy rates in multifamily real estate, indicate the wave of new supply has begun to enter the market in earnest.[5] The first quarter of 2017 marked an increase in the overall national vacancy rate, increasing from 4.2% to 4.4%.[5] Despite negative net absorption of 11,000 units and 77,000 apartment deliveries during the first quarter, average rent growth across the United States remains on track to increase by 3.8%.[5] We believe demographics continue to favor multifamily real estate. Investors may continue to benefit from the stable and cash flowing asset class albeit with moderating overall rent increases.

We believe core office has reached a cyclical peak and the greatest potential for capital appreciation may be in secondary markets, value-add and non-core space. Vacancy rates for office property across the United States increased by 10 bps to 14.8% from 14.7% during the quarter.[6] Vacancy rates are expected to rise over the next 24 months as new office buildings are completed.[6] The second quarter of 2017 marked the 29th consecutive quarter of positive net absorption, driven by the expansion and demand from technology tenants who were the drivers behind 8.4 million square feet of net absorption during the quarter. Seattle, Washington, led the pack, with 2.9 million square feet of year-to-date net absorption.[6] Class A asking rents grew by 3.7% yoy driving up the market average.[6] That said, concessions have increased as landlords seek to fill new developments and repositioned assets. Tenant improvement allowances have increased by 10.5% since 2014, demonstrating an increasingly competitive leasing environment.[6]

During the first quarter of 2017, the national industrial vacancy rate continued to decline, dropping 20 bps from the fourth quarter of 2016 to 5.3% and down 300 bps from the 10-year historical average of 8.3%.[7] Industrial real estate across the United States posted a net absorption of 53.8 million square feet of space in the first quarter of 2017, a 14.4% decline yoy.[7] That said, absorption in the first quarter of 2017 outpaced the quarterly average of 49.3 million square feet as posted during the current economic recovery.[7] Rental growth in the sector is being fueled by demand from third-party logistic services and healthy demand from industrial tenants.[7] Not surprisingly, US industrial asking rents grew by 4.2% in the first quarter of 2017 from a year ago, with as many as one-third of industrial markets citing double-digit gains.[7] In our view, demand is likely to grow for smaller and older buildings located closer to the urban core. These buildings are well-positioned for redevelopment, bringing product closer to the customer for faster delivery times.

Retail real estate across the United States posted a vacancy rate increase of 0.1% in the second quarter of 2017, up from 9.9% in the first quarter of 2017 to 10% in the second.[8] Of the sub-property types in retail, regional malls fared the best with an 8.1% vacancy rate with neighborhood and community centers posting a 10% vacancy rate, just below the peak of 11.1% as noted in the third quarter of 2011.[8] Occupancy growth has been dominated by tenants taking space in newly delivered projects where leases were signed as long as two years ago, accounting for nearly 80% of non-mall shopping center expansion during the first quarter of 2017.[9] New construction added just less than six million square feet of space during the first quarter, most of which was in neighborhood and community centers.[9] Development has begun to slow, with the Southeast being the exception, adding just under five million square feet of new space, most of which is located in Florida where population growth continues to expand.[9] Retail continues to evolve with successful formats changing to meet local tastes and continued demand for entertainment and lifestyle options. We believe retail that provides authentic experiences that are not replicable online or located in high barrier-to-entry markets, such as gentrifying neighborhoods, will provide attractive opportunities.

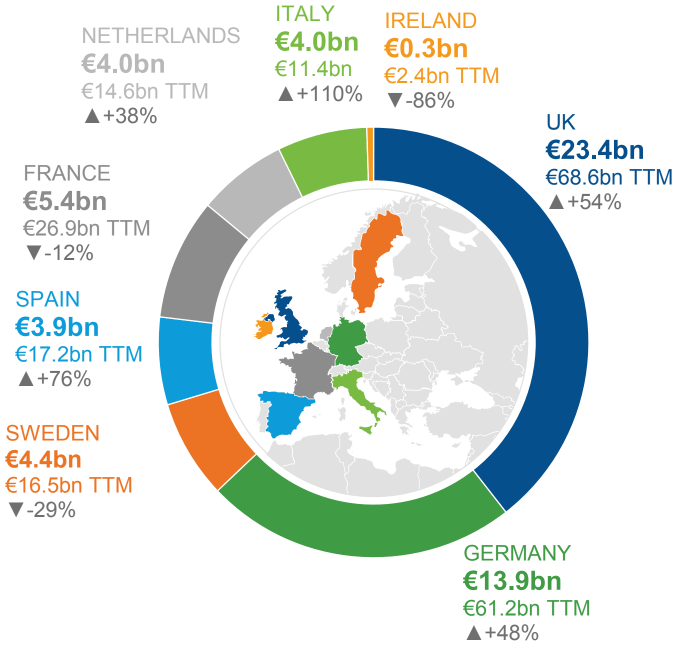
European Property Markets

- Overall, the European economy remained strong throughout the second quarter of 2017 as political concerns subsided after moderate, pro-European Union candidates scored electoral victories in France and are ahead in the early polls in Germany.
- In Germany, transaction volume increased significantly, reaching a 10-year high. Demand has continued to outpace supply, although supply has been slowly increasing over the second quarter.
- In the United Kingdom, a relatively weak pound sterling and favorable lease structures have driven overseas investor interest in trophy assets, especially in London.

The eurozone economy has emerged as a bright spot in global growth year-to-date, as incoming data has outperformed expectations. Economic sentiment is near a multi-year high and monetary policies have remained accommodative. Economic data suggest a 0.5% expansion in the second quarter 2017 GDP and further points toward a reduction in unemployment in the region. Support for populism across the bloc is on the decline with the French presidential election of Emmanuel Macron securing a strong mandate for economic reforms, and, in Germany, with Chancellor Angela Merkel showing a clear lead in early polls for the upcoming election. While uncertainty is clearly receding, it should be noted however that the persistent dividing political views will require necessary changes and compromises to the status quo. This is evidenced by the lengthy formation process of the Dutch government following its elections, the rejection of a new electoral law by the Italian parliament as well as the rising tension between the Spanish central government and Catalonia, which is planning to hold a referendum on independence in October. Meanwhile, the unanticipated snap election in the United Kingdom has not helped its economic activity which remains sluggish after weak first quarter GDP growth of 0.2%.

Chart 2: European Market Growth

European Commercial Real Estate Investment in Q2 2017
TTM = Trailing 12 Months
▲= Change on Q2 2016



Source: CB Richard Ellis Research, "European Investment Market Snapshot, Q2 2017."
The above chart is for illustrative and discussion purposes only.

In Germany, the commercial real estate market saw a total investment volume of around €14 billion in the second quarter of 2017, bringing the total for 2017 to around €26 billion, the highest level since 2007. More than half of the transaction volume consisted of deals exceeding €100 million, according to property consultant Savills. Domestic investors accounted for around 52% of the acquisition volume, while international buyers were dominated by investors from Asia according to property consultant Colliers. Investment demand continues to outpace supply, which is slowly increasing as developers have become the largest net sellers. Yield compression for commercial properties throughout all sectors continues, with strong rental growth expectations replacing low interest rates as the main driver. Prime office and retail yields in Germany's seven big cities are currently around 3.5% and are expected to persist at that level. Tenant demand for office space in the seven office hubs remains strong and managed to surpass the record take-up results posted in the first half of 2016 by around 3% due to an expansive job market and a strong German economy.

In the United Kingdom, the traditional long lease structure has acted as a safe haven for investors in search of income-producing assets amid increasing levels of global insecurity. This and the weaker pound sterling have renewed overseas investor interest in UK real estate, particularly for investors from Asia. In the first half of 2017, demand for trophy assets in the city of London was high with the 10 largest deals totaling £3.4 billion, compared with £3.1 billion across the whole of 2016, according to Savills research. With more trophy assets expected to trade in the second half of the year, total nationwide transaction volume is expected to exceed that of last year. The all-property UK prime yield has continuously sharpened, reaching an average of 4.75% in May 2017 which brings this yield back to its pre-Brexit level. Office take-up in London year-to-date through May is up 2% compared to this point last year. This increased occupier activity has been driven by demand from the technology and media sectors.

In Spain, investors' appetite for real estate assets remains strong, with office sales volume amounting to around €1.2 billion in the second quarter of 2017, according to the advisory firm JLL. Shopping centers and high street retail stores have again been the star sectors in the investment market, accounting for purchases amounting to around €1.5 billion. According to broker firm JLL, office take up in Spain in the first half of the year was strong both in Barcelona (+46% yoy) and Madrid (+25% yoy) with vacancy dropping another 50 bps in both cities given the lack of supply. There is further upward pressure on prime rents as availability in the Grade A segment in both cities has tightened and occupiers compete for the prime locations. During the last quarter rental growth continued apace, with Barcelona (+2.3% quarter-over-quarter [qoq]) and Madrid (+1.7% qoq) seeing further uplifts. Still, overall rent levels remain well below their previous peaks. Markets in the Benelux also witnessed high activity over the quarter with prime office rent growth in Brussels (+9.1% qoq), Luxembourg (+4.4% qoq) and Amsterdam (+2.7% qoq) as competition between occupiers for the limited space available intensifies.

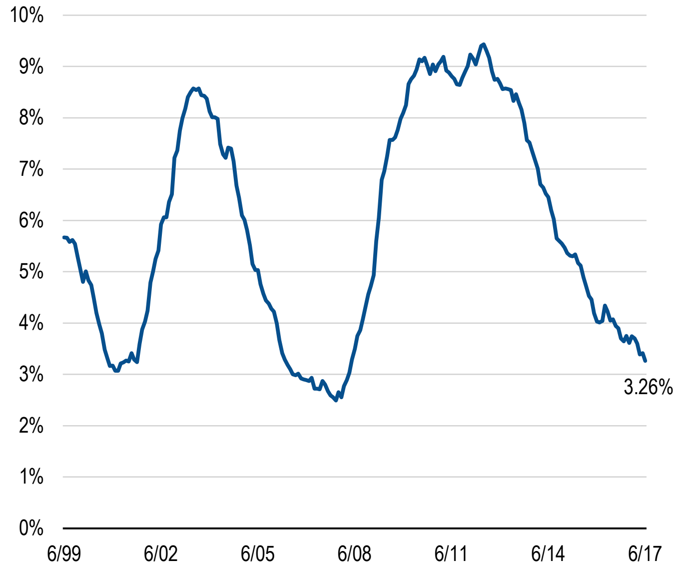
Asian Property Markets

- Growth in the Japanese private residential market slowed in the second quarter of 2017 as economic growth decelerated due to weaker domestic demand and lower oil inventories.
- Office fundamentals remain strong in central Tokyo, while vacancy rates for office property in second-tier cities such as Osaka and Sapporo tightened further over the quarter. Monetary policy is expected to remain accommodative, while government infrastructure spending has the potential to accelerate in advance of the 2020 Olympic Games.
- Chinese economic growth remained strong and overall transactional volume and fixed asset investment in the property market rose as a result. Liquidity concerns remain however, as financing costs rise amid tightening monetary policy.
- In India, new government action intended to renew investor confidence in local property markets has the potential to restrict supply in the short term.

According to the International Monetary Fund, the Asia Pacific region's GDP grew by 5.5% in 2017, mainly driven by robust domestic demand, and an increase in private investments, which offset the negative impact of rising interest rates. Regional trade and industrial production are expected to improve gradually. Monetary conditions in developed Asia remain accommodative, supported by still relatively benign inflationary environments, and tight labor markets. Most of the countries in the region are also well poised to experience expansionary fiscal policies over the next two years, as governments ramp up on infrastructure spending and social programs that will foster longer-term growth. In general, healthy jobs growth should support office occupier demand, and demand for retail. Moreover, modern logistics properties will benefit further from structural changes in consumption and e-commerce. Residential markets in most of developed Asia have been distorted by ongoing government and macroeconomic prudential policies to a certain extent, but historically regional investment demand for houses have been strong. Property yields across the region are close to historical lows, while demand for real estate exposure is expected to remain healthy.

Chart 3: Vacancy Rates in Tokyo Continue to Decline

Office Vacancy Rate (Tokyo Major Five Wards Average)
June1999–June 2017



Source: Miki Shoji. The above chart is for illustrative and discussion purposes only.

Japan's GDP grew by 1% yoy in the first quarter of 2017, based on the revised figures from the Japan Cabinet Office, down from an initial estimate of 2.2%, owing to revisions to weaker domestic demand and lower oil inventories. Private residential investment growth was 0.3%, compared to 0.4% in the quarter prior. The Miki Shoji office building vacancy rate survey of Tokyo's five main wards dropped to 3.26% over the quarter, from 3.60% as at March 2017. The average office asking rent per tsubo (approximately 3.3 square meters) for the five central wards of Tokyo increased over the quarter by nearly 0.7% to ¥18,864, which equates to a respectable 3.77% increase yoy. Local analysts believe demand for office space in central Tokyo remains firm, with the majority of the 2018 supply space (nearly 70%) being secured by tenants. A similar trend was observed in major regional cities including Osaka, Nagoya, Fukuoka and Sapporo where vacancy rates further tightened. Rental markets remained generally healthy in the high street retail and residential sectors in central Tokyo. Regarding the logistics sector, supply concern overhangs in some sub markets such as the Ken-o-do area in greater Tokyo, and the Osaka Bay area. With respect to monetary policy, the Bank of Japan's recent push-back of the projected timing for hitting its 2% inflation target means the central bank is unlikely to withdraw from its highly stimulative measures. Furthermore, fiscal policy is expected to remain supportive and government infrastructure spending should rise, as the pace of 2020 Olympics-related construction will likely pick up in the coming years.

According to the National Bureau of Statistics, China's GDP rose 6.9% yoy in the second quarter 2017, although it remained the same rate as the first quarter. This was also higher than analysts' expectations of a 6.8% growth, attributable to higher industrial and service outputs, and robust consumption as well as a pick-up in investment. China also reported that January to June fixed asset investment rose 8.6% yoy. During the same period, property investment rose 8.5% yoy. Retail sales meanwhile rose 11.0% in June from a year ago. As far as the real estate sector is concerned, some real estate developers are expected to encounter liquidity challenges over the next two years as a result of aggressive debt-fueled expansion between 2015 and 2016, with an estimated approximately ¥2.8 trillion ($411 billion) of loans outstanding. In addition, the narrowing of financing channels, coupled with the People's Bank of China's steady tightening of monetary policy, have contributed to the rise in financing costs to between two to three or as high as eight percentage points during the past six months, according to Xinhua Finance. On the bright side, the Chinese government announced measures in early 2017 to relax foreign direct investment restrictions on banking, securities, futures, mutual funds and insurance, while the exact timing of the measures coming into effect is uncertain. Under the new policy, foreign-invested, locally incorporated firms will be allowed to issue stock and debt in China. The implication for the real estate sector is that demand for real estate products, particularly offices, will increase. Shanghai, as the capital of China's financial and professional services industries, is expected to generate new occupier demand for the city's Grade A office market. The districts and business areas that are expected to benefit the most are the ones that offer the greatest incentives to multinational enterprises, good living and educational standards for their international workers and their families, and possess mature business environments with vibrant industry clusters. According to Savills, Shanghai's average core office rent rose again in the first quarter of 2017 by 0.3% qoq/2.5% yoy to ¥8.97 per square meter per day. Higher rents in the Pudong's Lujiazui central business district continued to help support city-wide rent growth in the first quarter of 2017, increasing by 0.5% qoq.

In India, the Real Estate (Regulation and Development) Act, 2016 (RERA) seeks to bring clarity and fair practices that would protect the interests of buyers (issues like delays, price, quality of construction, title and other changes), and also impose penalties on errant builders. The RERA intends to help improve investment sentiments in the real estate sector. It requires that all commercial and residential real estate projects need to register with the Real Estate Regulatory Authority before launching. The RERA also prohibits unaccounted money from being pumped into the sector and requires 70% of the money to be deposited in traceable bank accounts. All in all, the RERA demands greater transparency and accountability across multiple stakeholders and requires that developers provide accurate estimates regarding their projects as well as the sale agreement. That said, a moderate decrease in residential supply is forecasted in the short term, and only those developers who are capable of delivering projects on time will be able to continue to build. Although the long-term prospect of the residential sector is more optimistic given the growth in the country, the current weak sentiment in property markets, low absorption rates, and high level of inventory remain a challenge in the interim. The office market continued to look attractive during the first quarter of 2017, with Bangalore showing the lowest office market vacancy rate of 3.2% among all the top seven Indian cities. Bangalore and Mumbai accounted for 60% of the total absorption during the quarter, based on JLL research. With the information technology (IT) sector/companies targeting to reskill employees and changing toward a more agile model of software development and looking for alternative areas of growth, the IT sector/companies are delivering as well as creating jobs, which will translate to new office space requirements.

1. Source: US Federal Reserve.
2. Source: US Bureau of Labor Statistics.
3. Source: Organisation for Economic Cooperation and Development (OECD), Real GDP Forecast (Indicator). doi: 10.1787/1f84150b-en
4. Source: Real Capital Analytics, "May 2017 US Capital Trends: Deal Volume Falling, Not Sky," 23/6/17.
5. Source: Marcus & Millichap, "The Multifamily Spotlight," June 2017.
6. Source: JLL, "First Look at Office," Q2 2017.
7. Source: Cushman & Wakefield, "Marketbeat: US Industrial," Q1 2017.
8. Source: REIS, "Mall Vacancy Increases in Q2 2017," 11/7/17.
9. Source: Cushman & Wakefield, "Marketbeat: US Shopping Center," Q1 2017.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The risks associated with a private equity real estate strategy include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Real estate securities involve special risks, such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. Investments in REITs involve additional risks; since REITs typically are invested in a limited number of projects or in a particular market segment, they are more susceptible to adverse developments affecting a single project or market segment from more broadly diversified investments. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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