PrivcapRE/Briefing
Context for Private Real Estate Investment
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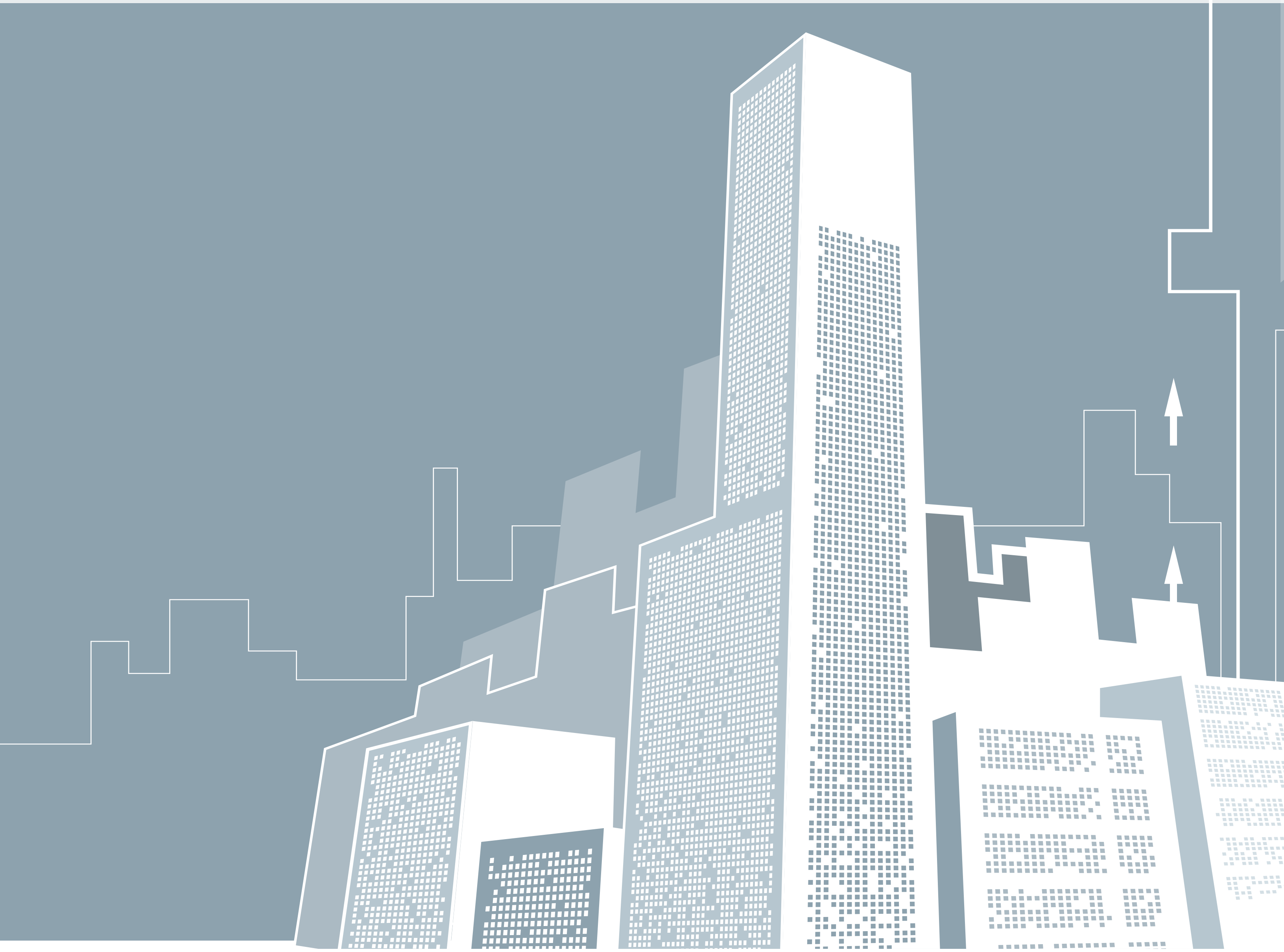
CRE Pricing Trends and Pitfalls in the U.S. & Europe

An executive summary of the PrivcapRE thought-leadership series "Understanding Real Estate Exit Strategies"



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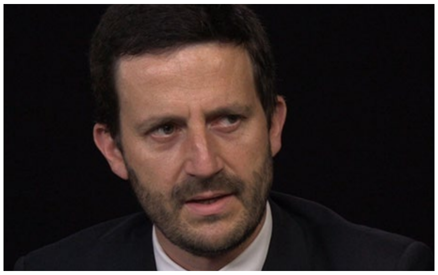
CRE Pricing Trends and Pitfalls in the U.S. & Europe

Key Findings

1. Commercial real estate sales are almost back to pre-financial-crisis levels
2. The return of the corporate real estate sector could affect pricing
3. Spread compression in U.S. core and peripheral markets has been significant
4. A cautious rental growth outlook is leading to lost deals
5. European CRE deals are attracting both traditional and new names
6. Banks in Europe haven't opened their books to investors and managers as originally hoped, meaning there are only organized sales and few discounts

The Panelists

Jason Fox
Managing Director,
Co-head of Global Investments
W. P. Carey



Olivier Thoral
Head of North America
AXA Real Estate

Jeffrey Lefleur
Managing Director
W. P. Carey

Gino Sabatini
Co-head of Global Investments
W. P. Carey

Dan Fasulo
Managing Director
Real Capital Analytics

Participating in the PrivcapRE thought-leadership series "Liquidity, Pricing and Opportunities to Sell" are Jason Fox, W. P. Carey; Dan Fasulo, Real Capital Analytics; and Olivier Thoral, AXA Real Estate

1. Commercial real estate sales are almost back to pre–financial-crisis levels

There's a lot of money—and competition—in the commercial real estate market, particularly in the U.S. and Asia. That means buying has taken precedence, especially with lower borrowing rates and stronger equity cash flows for investors.

"There is opportunity to sell in a market like this, and we take advantage of that by pruning our portfolio," says Jason Fox of W. P. Carey. "The spread between pricing or yields on marginal and high-quality assets is about as tight as it's been. But the focus is going to be on buying."

> **"It's a mistake to think of the banks as being in jeopardy or needing to do fire sales."**
>
> *— Jeffrey Lefleur, W. P. Carey*

Real Capital Analytics tracked more than $1T of property sales in 2013, which is almost back to 2007 levels, says the firm's Dan Fasulo, adding that for any type of core asset, there's a massive amount of liquidity globally.

For owners of core and fully leased properties, it may be time to sell, given pricing levels. Markets such as France, where there's more downside risk, are rich for sales, while sales of core assets should be considered if the money can be reallocated to more strategic, better-yielding opportunities.

"There are certain assets that should be sold," says Olivier Thoral of AXA Real Estate.

2. The return of the corporate real estate sector could affect pricing

There has been high liquidity in the commercial real estate market and rising prices, largely without a recovery in the corporate sector. The sale and leaseback market remains slow, as companies instead turn to the bond market as an alternative way to raise capital, says Fox of W. P. Carey.

"Now, as interest rates rise—and everyone expects them to, it's just a matter of when—we'll see more sale and leaseback activity," he says. "Sale and leaseback is a way to really lock in rental rates and yields over a long period of time, certainly much longer than bond financing can do."

3. Spread compression in U.S. core and peripheral markets has been significant

There has been a flood of capital coming into the U.S. commercial real estate market, leading to a significant tightening of spreads between core and prime property and secondary markets.

Gino Sabatini of W. P. Carey says there's money chasing assets on both the retail and institutional side of the CRE market, and people are searching for yield.

"It's a low-yield environment.... In a search for that yield, they're bidding up the prices of assets, pushing cap rates down," Sabatini says. He also expressed surprise that certain secondary markets that have historically commanded a premium are trading at a similar cap rate over yield to a primary market.

Office properties in the 10 largest U.S. markets, gateway cities, and growing metropolitan areas with a strong tech and education workforce have been a focus AXA Real Estate, says the firm's Olivier Thoral. Build-to-suit industrial also holds an attraction, because it's a way to get invested in certain income-producing properties with the right selection of partners, he says.

4. A cautious rental growth outlook is leading to lost deals

Underwriting rental growth is essential in prime markets like Manhattan but leads to fear when it involves properties in Chicago and Houston.

"What choice do you have?" asks RCA's Fasulo. "It's a decent bet in certain supply-constrained environments where vacancy levels have gotten back to the historical point where rents start to spike."

Sabatini says W. P. Carey doesn't factor in rental growth in its back-end residual value assumption, but does factor in the rents built into the lease. "We lose a ton of deals. I couldn't tell you how many we see every week—probably 100, and we do maybe 35 a year."

The only way to win core deals is through aggressive rent growth assumptions or a big sale price down the road, Sabatini says.

Thoral says that his firm underwrites an increase in cap rate over time to be on the safe side, also leading to lost deals.

5. European CRE deals are attracting both traditional and new names

The appetite for the CRE market in Europe has largely focused on London, Paris, and some German cities. This is especially true for Asian investors looking to pick up trophy assets in ultra-core markets "with a complete disregard for the rest of the market," says Jeffrey Lefleur of W. P. Carey.

Some companies with larger portfolios are starting to look at Ireland and Spain and other parts of Europe.

"There's a couple of wild cards out there," says RCA's Fasulo. "I wouldn't bet on Eastern Europe right now."

Participating in the PrivcapRE thought-leadership series "Exit Strategies: Pricing, Rental Growth and Competition" are Gino Sabatini, W. P. Carey; Dan Fasulo, Real Capital Analytics; and Olivier Thoral, AXA Real Estate

Participating in the PrivcapRE thought-leadership series "The Impact of Returning Liquidity in Europe" are Jeffrey Lefleur, W. P. Carey; Dan Fasulo, Real Capital Analytics; and Olivier Thoral, AXA Real Estate

He also notes that they've heard about "a lot of new Asian investors running around Europe right now."

About a year ago, new capital began flowing into Southern Europe. There have also been investments from Asian sovereign funds, along with some insurance companies from Korea. Thoral says that in some cases AXA Real Estate is partnering with these investors in both deals and for management services afterward.

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6. Banks in Europe haven't opened their books to investors and managers as originally hoped, meaning there are only organized sales and few discounts

While the U.S. banks have mostly worked their way through the distress cycle, their peers in Europe are in early innings.

Certain countries may be ahead of others, but it's been slow going, Fasulo says. As values have recovered a little and liquidity has come back, some are exiting at a gain, he adds, which was unimaginable a couple of years ago.

"It's a mistake to think of the banks as being in jeopardy or needing to do fire sales," says Lefleur, adding that they have gotten tremendous support from their governments and have shown an ability to ride out pricing and do organized sales of their portfolios, as demand is there and supply is limited.

Some banks took advantage of pricing prior to the financial crisis in 2008 and got a lot of deals done, Lefleur says.

There are processes at play in recovering countries like Spain and Ireland, allowing real estate to weather the worst of the recession and Euro crisis, says Thoral. Now they're able to sell loan or property portfolios at more attractive values.

"We've also acquired a lot of performing loans from banks during the Euro crisis—and for investors, that has also been an attractive play, because they have gained lots on those strong-performing loans," says Thoral, "and in a way the banks have sold during the Euro crisis some of their best assets...they couldn't afford the large losses." ◆

W.P. Carey is the sponsor of this briefing and the corresponding thought-leadership series.

Deal Story: Avnet

with Kathleen Barthmaier
Executive Director
W. P. Carey

Avnet is a global distributor of electronics components headquartered in Phoenix. The facility that we bought is the headquarters of one of their divisions, Global Technology Solutions, located in Tempe at Arizona State University Research Park. The facility was leased to them on a new 10-year term by a company called Piedmont. So we acquired the facility subject to the 10-year lease in December of 2013.

Historically we're known for acquiring 15-to-20-year leases, and in this case we were able to get comfortable with a 10-year lease for a few reasons. Avnet is a strong global company, so we weren't concerned for those initial 10 years. The real estate is in a beautiful location, and when Piedmont extended the lease, they actually reduced Avnet's rent. The rent is well below market, and the facility is important to Avnet, as it was a build-to-suit for them. It's the headquarters for their technology-solutions business, and we think they will be committed and stay and extend the lease. As we were analyzing the transaction, they decided to move forward with a solar panel project, which demonstrates their commitment to the facility.

Piedmont was motivated to exit the transaction to maximize their IRR returns with a shorter hold period. They also were focused on closing the deal before year end. So we had to move on a very tight timeline, and that's one of the reasons they chose to work with us—just the certainty of close. We signed the transaction in mid-November and had to close by December 30.

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Deal Story: Bank Pekao

with Jeffrey Lefleur
Managing Director
W. P. Carey

Bank Pekao was a big deal for us. It was €113M, €120M, which is a good-sized transaction for us, and we closed all-equity, which is a big chunk for most investors in Europe right now. The Bank Pekao building was their office headquarters. They're the second-largest bank in Poland, so you're talking about an operationally critical asset with a strong tenant. And the remaining lease was about 10 years—so from our perspective, a bit short, but by European standards, a good long-term lease in place.

A part of it is confronting the reality of what Europe can offer us. Our definition of long term is 15, 20 years, and there was a time when we could accomplish that. The reality of what the offerings are in Europe is that a common core-office lease is five to seven years, and beyond that is considered long-term. If we want to be competitive, buying core office, doing good deals like Pekao, we have to trade off some of that leasing risk.

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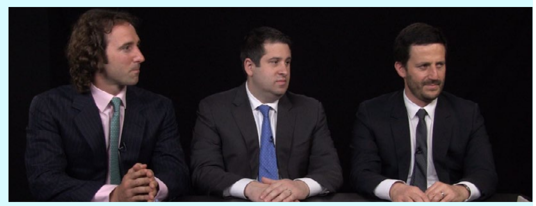
PrivcapRE/ Thought Leadership for the Private Real Estate Markets

Series / CRE Pricing Trends & Pitfalls in the U.S. & Europe



Watch these panels in their entirety at **PrivcapRE.com**

- Liquidity, Pricing and Opportunities to Sell
- Exit Strategies: Pricing, Rental Growth and Competition
- The Impact of Returning Liquidity In Europe

This thought-leadership series is sponsored by W. P. Carey.

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