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STRATEGY NOTE

Markets at Inflection Point:

The Case for Real Estate

NBK CAPITAL
INVESTMENT STRATEGY & ADVISORY

HIGHLIGHTS

- **The global financial crisis shifted the dynamics of the market**, pushing interest rates to record lows and swelling central banks' balance sheets. **Investors are increasingly looking at alternatives** to manage risks and achieve targeted returns.

- The **fixed income bull market is dwindling** and **volatility is at an all-time low, creating a false feeling of safety**. Over the past few years, **traditional asset classes appear to be more and more correlated to each other**, greatly reducing the benefits of portfolio diversification.

- **Adding alternatives to a traditional investment portfolio enhances risk-adjusted returns and reduces volatility**.

- **Sovereign wealth funds have already jumped on the band wagon** and increased allocations to alternative asset classes while reducing exposure to equities and fixed income.

- **Among alternatives, real estate is one of the most popular investments among GCC investors.** Exposure can be achieved via private debt, private equity, public debt or public equity.

- Real estate investments offer attractive returns, portfolio diversification, and hedge against inflation.

THE STATE OF GLOBAL MARKETS

The global financial crisis started with a collapse in the housing market in the United States then soon developed into a full-fledged financial crisis that swept the whole world. Governments and central banks around the globe embarked on a coordinated series of measures aimed at containing the effects of the crisis, shoring up financial institutions and corporates, and even some governments that were on the brink of bankruptcy, and restoring confidence in the financial system. This ultimately translated into record low interest rate levels, even negative in some instances, record levels of liquidity, and swollen central banks' balance sheets.

Almost ten years after the onset of the crisis, the US Federal Reserve is gradually reversing its expansionary monetary policy, and signs that other central banks will soon follow suit are starting to emerge. The timing and the quantum of the reversal has been the subject of much debate though. Economic growth has been steadily improving, but this improvement has been slow. The US job market has also been improving with the unemployment rate at 4.4% but wage growth is barely moving. This, along with low energy prices, among other factors, have resulted in a stubbornly low inflation that is still falling short of the Fed's 2% target.

Accommodative policies designed to counter the effects of the financial crisis did have significant side effects, however. Easy or free money, being the main distinguishing factor of the past decade, has arguably caused dislocations in asset prices globally, especially in fixed income. Equity markets have also been a major beneficiary and the bull market in US equities is still raging for the ninth year after markets bottomed out in March 2009.

How will financial markets react to policy normalization seems to be the main concern of investors at this point and has been for some time. The risk that equity markets would go into a correction is becoming an increasingly probable scenario, while the fixed income market would obviously be the first to feel the burn from a reversal in interest rate policy.

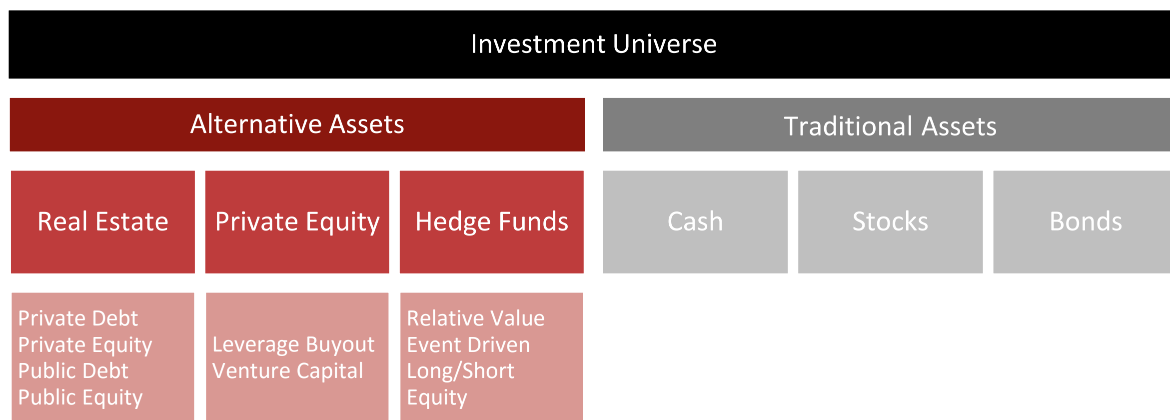
Against this backdrop, it has become increasingly important for investors to find ways to control market risk in their portfolios while looking for sources of enhancing overall return. Many investors, both high-net-worth and institutional, started to consider illiquid strategies as a complementary alternative to traditional asset classes, despite some perceived shortfalls of the former.

UNDERSTANDING ALTERNATIVE INVESTMENTS

Alternative investments can be broadly defined as assets that are not part of the traditional asset classes of cash, stocks, and bonds. Alternatives can range from real assets, such as real estate and commodities, to intangibles like private equity and hedge funds. Alternative investments are not new; hedge funds have come into prominence over the past few decades but have been around since 1949; venture capital, which entails investing in young companies and startups that are not publicly traded, set its roots in the 1940s, while investing in real estate has been around for centuries.

Most alternative investments have an absolute performance objective – meaning their goal is to produce positive returns regardless of market conditions, unlike traditional assets that seek to generate alpha or outperform a benchmark. Alternatives have little correlation with traditional financial assets over long time horizons, are usually illiquid, and have multi-year lock-up periods. Overall, adding alternatives to a traditional investment portfolio results in enhanced risk-adjusted returns. It will reduce the volatility of the portfolio as such investments are not usually traded on active exchanges and therefore are not marked-to-market.

Chart 1: Investment Universe



Source: NBKC

Over the past few years, interest in alternative investments has spiked as investors sought higher returns in today's low return environment. Sovereign wealth funds, pension funds, endowments, and other institutional as well as individual investors have been increasing their portfolio allocations to alternatives, aiming to achieve enhanced portfolio diversification and a better risk-return payoff compared to traditional investments.

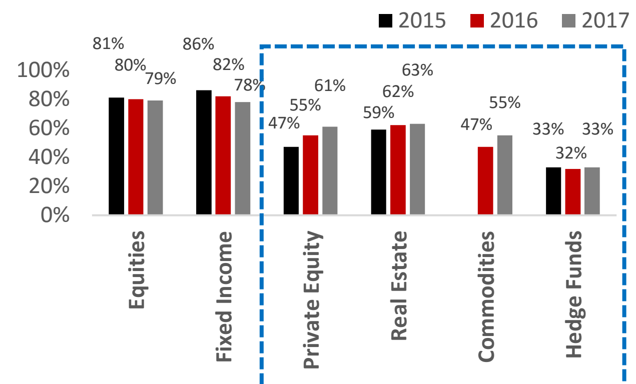
According to the 2017 Preqin Sovereign Wealth Funds Review, an increasing number of sovereign wealth funds (SWFs) are adding allocations to alternative asset classes including private equity, commodities and real estate while reducing exposure to equities and fixed income (Chart 2). With the drop in oil prices, SWFs, and especially those that are hydrocarbon funded, are under pressure to generate adequate returns. While alternatives may be new to some, these investments have become a key part of the asset allocation for many qualified investors.

Table 1: Harvard Endowment - Strategic Asset Allocation

	1995	2005	2010	2016
Equity	58%	30%	33%	29%
Fixed Income	22%	27%	13%	13%
Private Equity	12%	13%	13%	20%
Absolute Return	0%	12%	16%	14%
Real Estate	7%	10%	9%	15%
Commodities	6%	13%	14%	10%
Cash	-5%	-5%	2%	0%
Total	**100%**	**100%**	**100%**	**100%**

Source: Harvard Management Company

Chart 2: Sovereign Wealth Funds Investing in Each Asset Class



Source: 2017 Preqin Sovereign Wealth Fund Review

Why Invest in Alternatives?

Volatility at All-Time Lows

2017 can be characterized as a year of subdued volatility – market volatility, that is. The Chicago Board Options Exchange's implied volatility index, also known as VIX, has fallen 27% this year and dipped below 10% in May, near its low of 9.7% set in February 2007, before the onset of the financial crisis.

While market volatility has been unusually low, there was no shortage of what can be termed as "pent-up" volatility. The world has experienced a significant amount of uncertainty over the past year. Starting with the surprise outcome of the Brexit vote and the US elections, to political concerns around the future of the European Union with a series of elections, the last of which was France's presidential elections, in addition to various geopolitical tensions around the globe. Markets, however, seemed to completely ignore or recover from each in a matter of days or even hours. This "indifference" in the equity market seems to be leading investors into complacency and into a false feeling of safety that is compounded by the fear of missing out.

Such a mix would result in investors taking excessive risks and could ultimately lead to a more severe correction in equities when it happens. Granted that this calm in the market could be driven by stable and moderate economic growth and low inflation, but historically, more often than not, this has been a sign of an impending market correction when the coiled spring of volatility is let loose.

Chart 3: Market Volatility: VIX Index

Source: Yahoo! Finance and NBKC

Fixed Income Bull Market Dwindling

The 35-year bond bull market seems to be running out of steam. The yield on 10-year US Treasuries was around 14% in 1981. It has been trending down consistently ever since and reached 2.3% as of May 2017. The bull run in the fixed income market was stretched to the limit during the past eight to nine years, propelled by coordinated expansionary monetary policies globally. Now that policy normalization is starting to get underway, the party seems to be almost over.

Chart 4: 10-Year Treasury Constant Maturity Rate

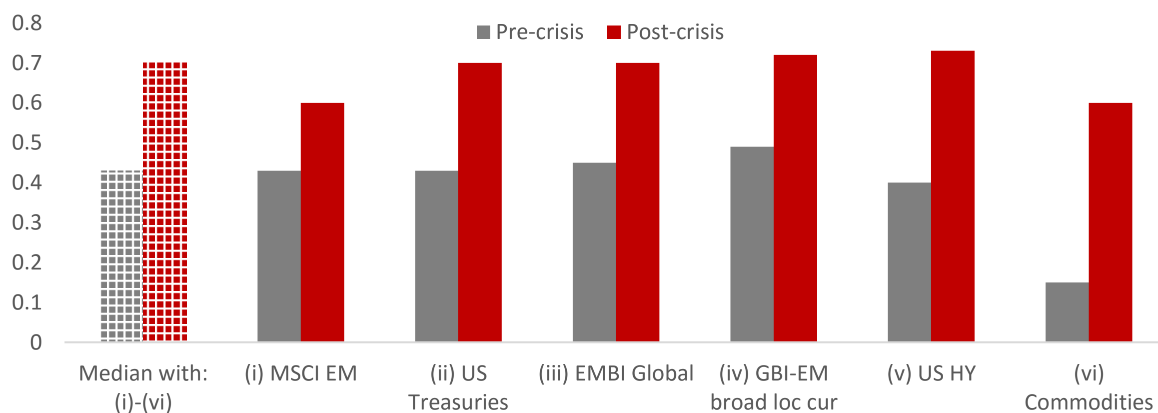
Source: Board of Governors of the Federal Reserve System (US), retrieved from FRED, Federal Reserve Bank of St. Louis

In such an environment, when market indices are at historical highs and monetary policies around the world are at an inflection point after almost a decade of very accommodative policies, it would be prudent for investors to mitigate such market risks by increasing exposure to assets that are uncorrelated with the liquid markets whenever possible.

Diversification within Traditional Asset Classes Not as Effective in Times of Crisis

After the global financial crisis, correlation across asset classes became higher compared to pre-financial crisis, thus creating difficulty in truly diversifying investment portfolios. According to analysis presented in the IMF Global Financial Stability Report issued in April 2015, “Correlations among risk-adjusted returns of major asset classes have increased markedly since 2010. The correlation of the S&P 500 with U.S. high-yield indices has shown a steep increase, and the correlation with commodities has increased fourfold.”

Chart 5: Correlation Levels Among Major Asset Classes vs S&P 500



Source: IMF – Global Financial Stability Report
** MSCI EM = MSCI Emerging Markets Equity Index; U.S. Treasuries = 7–10-year U.S. Treasury Index; EMBI Global = JPMorgan Emerging Markets Bond Index Global; GBI-EM broad loc cur =JPMorgan Government Bond Index-Emerging Markets in local currency; US HY = U.S. High-Yield Index; Commodities = Credit Suisse Index*

Although cross-asset correlations change in magnitude and direction over time, the trend in the past few years has been very clear in the sense that correlations across asset classes have been relatively high. This is especially true when looking at equities and fixed income which have been moving in tandem since the beginning of the decade. Market participants and analysts attribute this to the various accommodative central bank policies which were aimed at containing the effects of the financial crisis.

An environment of stronger global correlations makes it more challenging to construct a truly diversified and resilient portfolio, because assets that were previously unrelated can now represent exposure to the same risk factors and thus alternatives offer a great option for diversification.

SOLACE IN BRICKS AND MORTAR

Within the wide range of alternative investments, the focus of the following sections will be on various forms of real estate investments, given that this class has been very popular in the GCC region.

Real estate has long been a mainstay investment among GCC investors, whether it be investing in a home or an income-generating property. The concept of "bricks and mortar" and high tangibility attracts many investors to real estate over fixed income or equities. Unlike stocks or bonds, an individual investor can touch and see a property, thus providing tangible comfort. The trend of increasing allocation to real assets has not been restricted to individual investors though. With major global equity markets at historical highs and fixed income yields at historical lows, long-term institutional investors have been increasing allocations to illiquid investments in general. Real estate, in particular, has been getting considerable attention lately due to its income-producing characteristics and its potential of generating long-term capital gains.

The real estate market is massive in size and as an asset class is comprised of diverse sub-asset classes ranging in liquidity and differing in risk-return profiles, thus satisfying different investor profiles. The risk and return attributes may greatly vary across different real estate investments but these attributes are not the only ones to be considered when investing. Typically, a real estate investment entails exposure through the equity of the capital structure; however, it can be attained through debt structures, as well. The public equity real estate market is the most liquid, transparent and heavily researched sector. Debt markets, on the other hand, are growing rapidly in size and sophistication, opening a new range of opportunities to investors seeking enhanced yield and management of risk. However, a successful investment in these markets requires expertise in credit assessment and financial structuring.

Table 2: Real Estate Sub-Asset Classes

	GROWTH	YIELD
STABILITY	Private Equity	Private Debt
LIQUIDITY	Public Equity	Public Debt

	EQUITY	DEBT
PRIVATE	-Direct investments -Non-listed real estate funds	-Direct mortgages -Private real estate debt funds - Mezzanine
PUBLIC	-REITs	-Mortgage backed securities -Bonds issued by real estate companies

Source: NBKC

Private Real Estate Investment Funds - Private Equity or Debt

High net worth individuals and institutions can gain exposure to real estate through private investment funds or other types of collective investment vehicles. Such funds are usually close-ended, allowing investors to commit a fixed amount of capital for a specified period, usually ranging from five to ten years. Capital is thus pooled from multiple investors and deployed pursuant to a specific investment strategy such as development, redevelopment, sale-leaseback, or other strategies. Funds of this nature typically aim to distribute income to investors and may have the potential of capital gains depending on the specific strategy and fund objectives. The equity-like characteristics of income and capital gain potential, combined with low correlation with equity markets and low volatility, make these types of investments very appealing to a large group of investors.

All types of investment entail some kind of investment risk and real estate is no different. Real Estate investment risk could be derived from external sources such as macro-economic factors that could be mitigated through geographic diversification. Risk could also be property or structure specific. Such factors range from location, quality of tenants, level of leverage, credit quality of the developer should the exposure be derived from financing, or amount of investment needed to make a property cash productive. Depending on the riskiness of future cash flows and the corresponding potential return, real estate investment could be grouped into four major categories: core, core-plus, value added, and opportunistic.

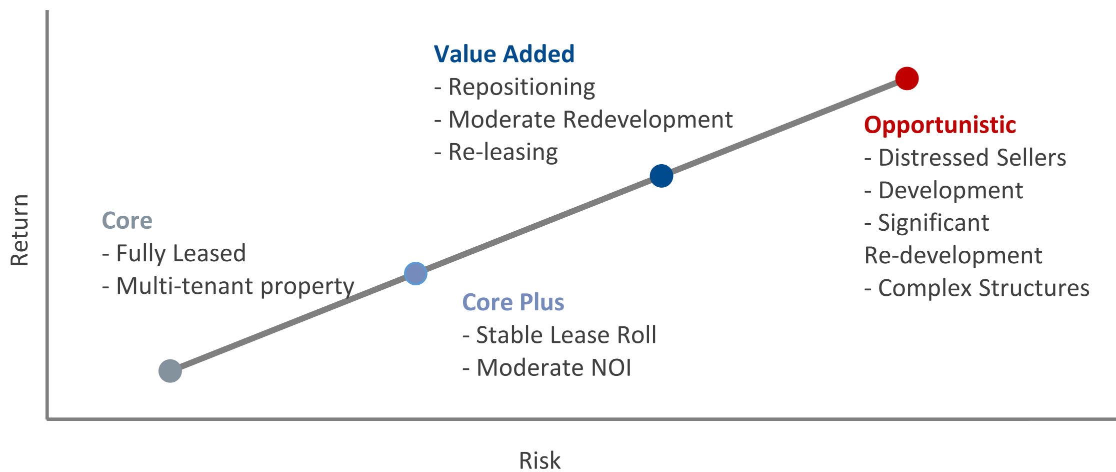
Core *Low risk, low return. Core properties are relatively stable assets investing in office, retail, industrial, or residential segments in well- established urban locations. Properties are well maintained, have high- occupancy, low debt, and stable cash flows. Within core is sale lease-back transactions where the owner sells the property then leases it back from the buyer. In this way, the transaction functions as a loan, with payments taking the form of rent.*

Core-plus *Moderate risk, moderate return. This class is similar to core, but not as high quality. Core assets require value-add like increased occupancy, better management, etc. This asset class can be typically found in primary or secondary markets. Moderate leverage can sometimes be used.*

Value Added *Moderate to high risk and return. This asset class typically targets properties that have cash flows, but seek to increase cash flows over time by making improvements to or repositioning the property. Value added activities are through operations, leasing or redevelopment. Leverage can come up to 70% and appreciation of the property value is a significant part of expected return.*

Opportunistic *High risk, high return. This asset class follows the value add approach but takes it a step further on the risk spectrum. Opportunistic properties usually require significant rehabilitation in order to realize their potential. This may Involve repositioning of poorly managed, obsolete, or high vacancy properties. The asset may be a new development or conversion.*

Chart 6: Real Estate Investment Categories



Source: NBKC

Direct Real Estate Investing

Direct real estate investing involves the direct purchase of property or buying a stake in a property, either through debt or equity. Senior debt is usually provided by a bank in the form of a mortgage and common equity is capital usually put up by sponsors. Debt providers consist of big players such as banks or insurance companies. In recent times, focus has shifted towards the middle of the capital stack. This is most commonly in the form of mezzanine debt and preferred equity components of the stack.

These types of hybrid-like investments fall in-between senior debt and common equity, and are widely used by institutional investors. They offer the best of both types of financing; function like debt in certain cases in terms of lower risk and like equity in terms of higher return. While the line separating mezzanine debt and preferred equity investments can be blurry at times, they do have their differences.

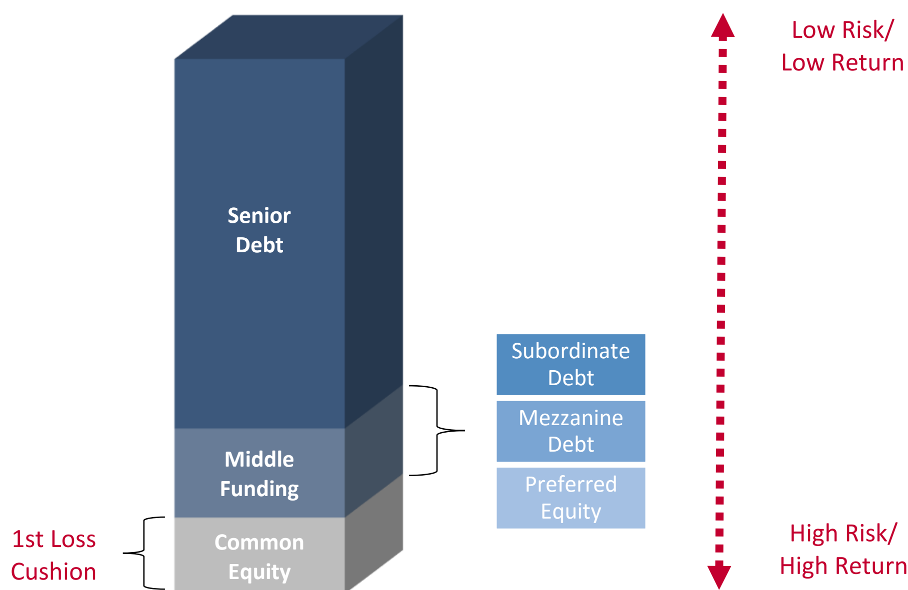
The main differentiating factor is that mezzanine debt is structured as a loan secured by the subject property, whereas preferred equity is an investment in the property-owning entity. In a mezzanine structure, the investor provides funding with recourse to the total equity in the property. In a preferred equity structure, the investor partially owns an interest in the entity that invests in or owns the property.

Mezzanine financing is a form of private debt that is subordinate in priority of payment to senior debt but more senior to equity. The maturity of such investments is medium-term, typically four to eight years, depending on the transaction’s structure. Many mezzanine debt investments offer a cash coupon with a fixed rate, paid semi-annually or quarterly, while others may offer a floating rate or pay interest in-kind.

Preferred equity investments typically offer current returns at times with upside potential via an equity kicker, meaning that extra returns can be captured depending on certain milestones or hurdle rates. Similar to mezzanine debt, these can also be medium to long-term investments. In addition, preferred equity is usually subordinate to mezzanine debt (depending on the structure) and senior to common equity. The key differentiator is that cash flows in preferred equity investments are usually structured to be in a priority position above equity cash flows. However, there is no clear obligation to payout cash flows to investors if the asset is not generating enough income. In mezzanine, the equity in the deal is obligated to pay coupons at a set rate and nonpayment is a default that could trigger enforcement over the equity position.

The capital stack (Chart 7) depicts the total sources of funding for a typical real estate investment. These can vary in structure depending on the nature of the transaction and negotiations between the related parties. There are two ways to look at it: from a returns perspective and from a risk perspective.

Chart 7: Capital Stack



Source: NBKC

On one end of the capital stack, senior debt offers the least amount of risk and first priority of payment. However, it also yields the least in terms of return. On the other end of the capital stack, common equity offers the highest returns, usually in the double digits, to compensate for its higher risk. They get the last trickle of the cash flows, meaning if there are severe enough losses, the equity investor has the potential to earn nothing.

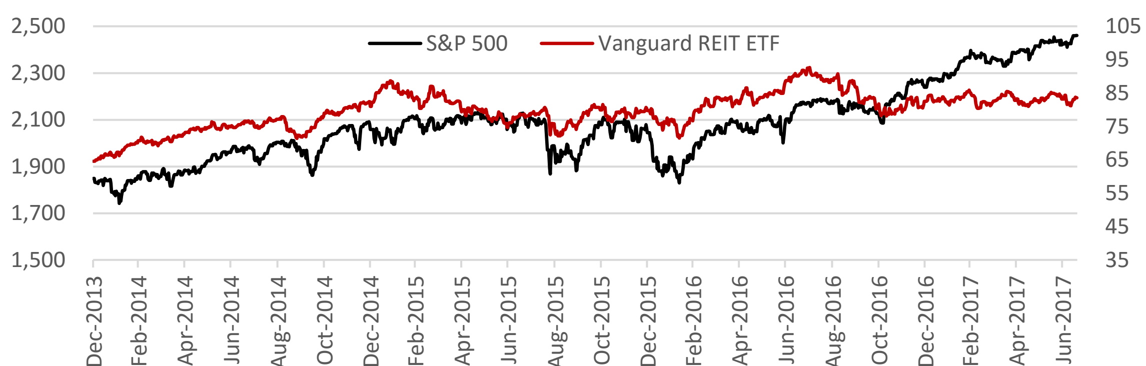
In the middle, where a funding gap would typically exist, mezzanine and preferred equity investments are more risky than senior debt but usually offer higher returns. However, investors' capital is still protected by the equity subordinate, commonly referred to as a first loss equity cushion.

Those searching for yield but are sensitive to risk usually find mezzanine debt and preferred equity investments as more efficient risk-adjusted structures.

Real Estate Investment Trusts - Public Equity

Real estate investments trusts (REITs) are special vehicles that offer access to diversified real estate by financing or owning real estate. REITs are usually exchange listed with relatively small denominations and offer higher liquidity than other forms of real estate investments. Similar to stocks, REITs may promise investors dividends and capital appreciation. However, one of the downsides of REITs are their higher volatility and higher correlation with equities.

Chart 8: REITs Correlation with Equities



Source: Bloomberg

WHY REAL ESTATE?

Diversification

The benefits of diversification of an investment portfolio have been well documented. Real estate offers diversification benefits on two levels; low correlation with other assets classes and low correlation across geographies and strategies. Adding real estate to an investment portfolio can increase the benefits of diversification, while reducing volatility and enhancing returns. Investors can also benefit from the diversification potential from a global standpoint, as most real estate markets in different countries are usually at different cycles. If a portfolio is invested only in the home market, all real estate, as well as other assets, will always be subject to the same macroeconomic trends, such as demographic changes, inflation, and regulation.

Hedge against Inflation

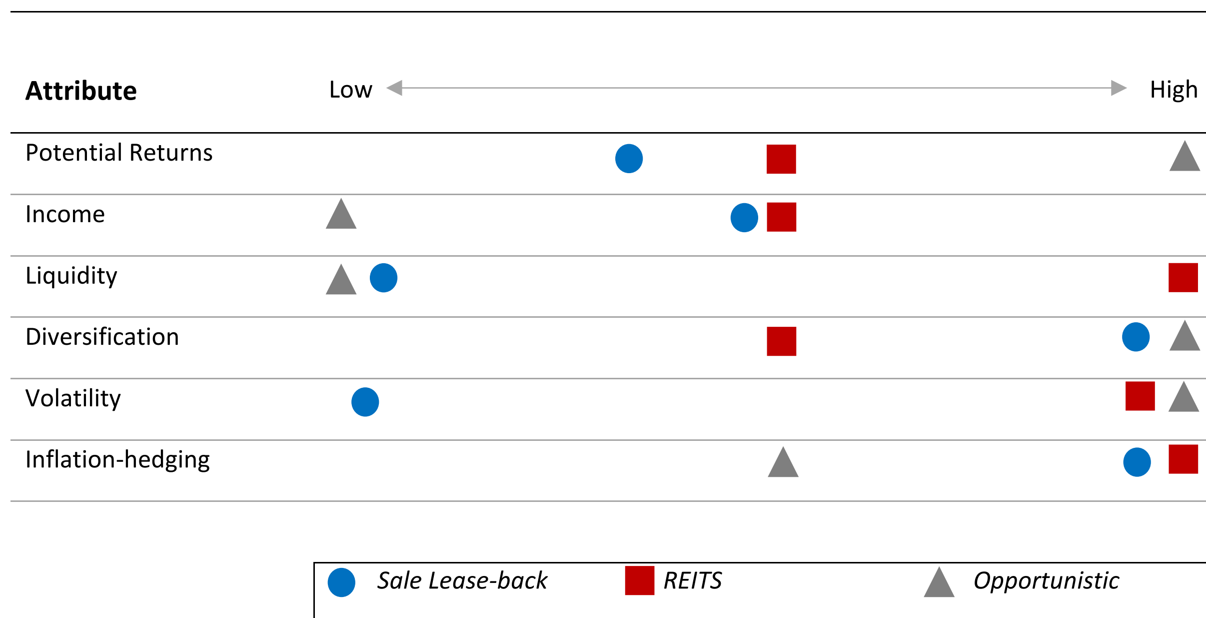
Real estate offers investors partial protection against rising inflation, similar to some commodities. As global interest rates hover at historic lows, investors are apprehensive of the prospects of a rise in inflation. In the world of real estate, as inflation occurs, property value

goes up. Some rental contracts are short term and thus eventually adjust to inflation on renewal, while other contracts are medium to long term with built-in inflation clauses which allow for a preset level of adjustment to compensate for rising price levels.

Attractive Returns

Real estate returns are considered to be attractive and are derived from two components, one similar to a bond and the second similar to a stock. The first component is a stream of cash flows, the rental revenues, and the second is the potential growth, the capital gain, in the value of the property. Real estate cash flows, unlike bonds, are not fixed and may fluctuate based on tenant composition, for example, the number of vacancies, or due to the adjustment of rental rates on a per sqm/sqf basis. In terms of value, real estate fluctuations tend to be cyclical and less volatile when compared to stocks. Moreover, the total return of real estate may be heavily impacted by the level of involvement in the asset by the investor compared to other types of investments. Value add strategies, such as refurbishing, remodeling, or simple additions, if correctly implemented may increase cash flow as well as resale value.

Table 3: Investment Attributes of Different Real Estate Investments



Source: NBKC

Final Thoughts

The global economy needed a great deal of support in terms of accommodative and counter-cyclical policies to avert the effect of the global financial crisis. Almost a decade after embarking on such policies, it seems that the time has come to start what is increasingly looking like a long drawn reversal process.

With financial markets at historical highs, arguably propped, at least in part, by expansionary policies, withdrawing such accommodation, no matter how "measured" and "gradual" this withdrawal would be, carries a certain level of risk for both equity and fixed income markets. Furthermore, the turbulent geopolitical landscape creates further uncertainties. Under such a scenario, investors have been increasingly directing funds to alternative investment, including real estate, as a means to diversify and hedge investment portfolios.

The alternatives asset industry is vast and continues to grow. As investors, both individual and institutional, face many challenges today, investing in alternative asset classes satisfies a number of their needs. The case for real estate is stronger than ever. Qualified investors are looking for yield, some for higher returns, or protection from rising rates, or a haven against market volatility—or some combinations of the above. The many different real estate investment options help address a variety of investor objectives. Real estate used to be a mainstay investment for institutional investors and the wealthy, but now they are becoming available for a wider group of investors, whether it be through funds, REITs, or other vehicles.

Contacts:

Investment Strategy & Advisory
Asset Management

Arraya Tower II, Floor 35
P.O. Box 4950, Safat 13050, Kuwait

T. (965) 2224 5111
F. (965) 2224 6904
E. NBKCAPITAL.IA@nbkcapital.com

NBK·CAPITAL

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