AF | Advisory

REAL ESTATE DEBT & EQUITY

AF ADVISORY - THE HOLISTIC VIEW

Contents

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Executive Summary

Increasing political risk affects real estate investments more than many other asset classes, as the long-term nature of real estate investment, its immovability, limited liquidity and comparatively large investment size, renders many risk mitigation strategies ineffective.

This newsletter tries to define and explain seven practical indicators investors should use to assess political risk and propose timing and suitability considerations for investors, centred around the topic of political risk.

We conclude that the investor's (political) risk appetite and desired hold period should not only define which asset class, strategy and location, but also which country the investor selects.

II: The most important market indicators can be found at the end of this newsletter.

III: We are attending MIPIM 12th - 16th March 2018 in Cannes. For appointments please contact: silke.neumaier@AFAdvisory.com

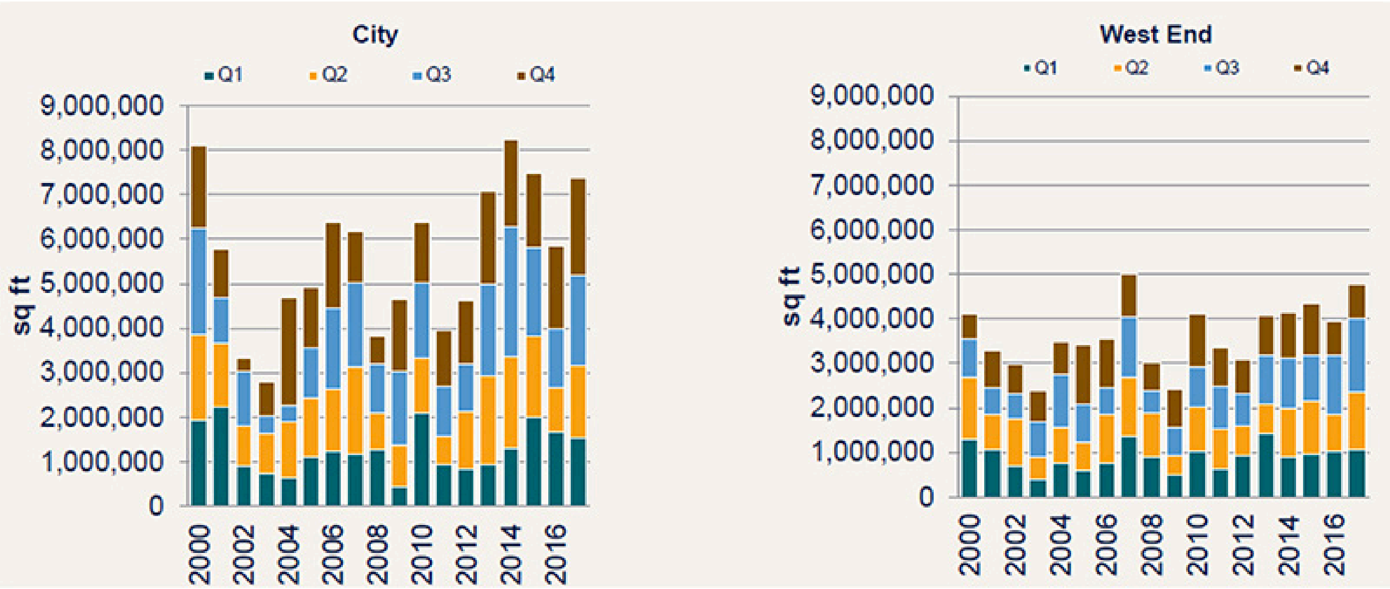
When the author told the PERE Conference in Frankfurt in February 2016 that political risk, including Islam-inspired terrorism, would become key issues that needed to be considered in investment decisions, the response was silence and surprise. To my delight, Dr Gertrud Traud, the highly-regarded chief economist of Helaba, spoke immediately after me, concurring that the key risks nowadays are political.

Looking back over the last two years and forward into the future, political risk and Islam-inspired terrorism have made their mark and remain two key concerns.

But what does political risk mean in practical terms, and is it a real risk with financial consequences?

After all, the UK's Brexit vote only led to a short hiatus in transactions, with investment and take-up of office space in London's City and West End returning to very robust health in 2017. West End take-up was the second highest and City take-up the third-highest since 2000,[1] a confirmation of our sanguine analysis "Brexit – Looking beyond the noise!", issued four days after the Brexit vote and still worth reading today (see the news area of our website, http://afadvisory.com/news/)

London Take-up 2017



(Source: Savills, London Office Outlook, January 2018)

On the other hand, Turkey's spectacular fall from being a darling of the investment world due to its growing, young, productive population, illustrates the impact of political risk and the rapid decrease in values and liquidity which investors can suffer in politically volatile markets.

Since our presentation, we have been told that the term "political risk" is too vague, and we were asked to make it more tangible. We have therefore created "AF Advisory's 7 Political Risk Criteria" © which we present below, and which should help our clients assess political investment risk more consistently.

Political risk increases when a country does not fulfil all the following criteria

1. Absence of internal and external strife caused by the country's leadership, population or neighbours,
2. clear and reliable regulations governing ownership of assets/property,
3. consistent, predictable and equitable rule-of law (legislature, judiciary and executive),

4. predictably- and well-managed economies,
5. judicious, fair and consistent tax system,
6. stable population (including controlled migration) supportive of the existing political system and status quo,
7. a political class and environment focussed on achieving/maintaining the above.

The more of the above criteria are absent, the stronger the potential impact on the value and liquidity of investments.

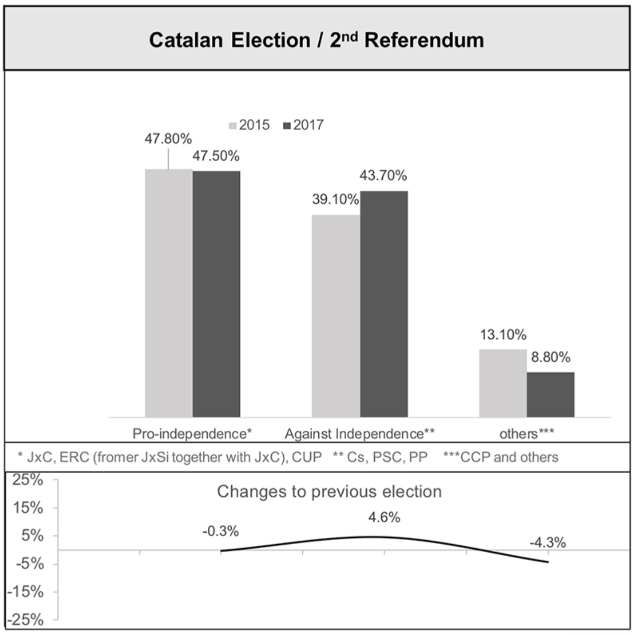
Let's discuss them in turn:

1. Absence of internal and external strife caused by the country's leadership, population or neighbours

Investments in countries ravaged by internal or external strife, for example parts of Africa and many countries in the Middle East, are under existential threat where not only the income or liquidity of the asset is threatened, but its very existence. Note that such threat does not need to be the result of the actions or inactions of the relevant country (e.g. South Korea, Israel, India) but can be purely a result of that country having one or more borders with aggressor countries "exporting" political risk.

Internal strife is becoming more prevalent globally and thereby more important for investors to watch. This is often rooted in ethnic or historical divisions and may be as destructive and violent as external strife. Extreme cases are Syria, Afghanistan, Yemen etc. but even smaller scale events like in Tunisia and Egypt can cause the country significant economic harm, and with declining economies the value of investments in these countries tends to decline.

Strife comes in many forms, from extremely threatening to merely inconvenient. But even internal dissent without major violence can cripple economies and have a pronounced effect on investments. The UK's miners' strikes during the 1980s were hugely disruptive to the economy and could have caused serious long-term damage had they gone on for much longer. The independence movement in Catalunya could lead to repeated general strikes and disrupt the local economy over an extended period. It is difficult to suppress a people's wish to vote in 21st century Europe and the grievances the Catalonians carry from the Franco years will make this a difficult to solve issue. As in most independence moves, there is no clear majority for either decision, making it impossible to find an all-round satisfactory solution.



(Source: www.politico.eu)

2. Clear and reliable regulations governing ownership of assets/property

The value of any investment is based on the assumption that the individual's rights to property and assets are upheld and defended by the state. This is a point, investors are particularly sensitive about. Investors can live with all kinds of political risk but a high likelihood of physical destruction (see 1.) or expropriation is a threat most investors are unlikely to accept. A good example of this is Turkey, once the poster-child of emerging investment destinations. While investors were struggling to put up with an ever more autocratic environment under Prime Minister/President Erdogan, the large-scale expropriations of individuals and companies accused of having connections with the Gulen movement following an opaque coup d'état in 2016 was a significant blow to investor confidence and desire to invest in Turkey[2].

If a Corbyn government were to come to power in the UK and enact its plan of nationalising key parts of the UK economy, including; power utilities, water companies, mail delivery and rail transport[3] this would also dent investor confidence markedly. "We could see the biggest shake-up in the political backdrop since the Seventies. This is much more scary from an equity perspective than Brexit," said Graham Secker, Morgan Stanley's chief European equity strategist. The bank said the "double whammy" of Brexit and a Labour government together could prove toxic for UK stock markets, with the bank's full-blown 'bear case' leading to an economic recession and a 32pc crash in the FTSE 100 index by 2019.

Nationalisation of assets casts a shadow over any other investment in that country. The remarkable fact is how little excitement this announcement has caused outside of the UK and how poorly it and the hard-left agenda of the Labour party under Jeremy Corbyn have been reported outside of the UK. The failure of Carillion is likely to lead to a further hardening of this stance, however economically weak the reasoning behind it.

3. Consistent, predictable and equitable rule-of law (legislature, judiciary and executive)

Again, this is not an issue in most Western countries where stand-offs between different levels or between the three powers of the state are very uncommon. A current example is the tussle between the legislature and judiciary in the Maldives, where two High Court Judges were taken to prison, leading the remaining High Court Judges to annul the judgement which caused the controversy[4],which resulted in a state of emergency. Another example is the stand-off in Turkey, where a lower level of judiciary refuses to implement decisions of their Supreme Court. [5] Investors' trust in the rule of law can be significantly undermined in an environment where many questions are asked about the independence of the judiciary. Disobedience by a lower court is a major issue, as it in effect dissolves the typical path of redress, where plaintiffs dissatisfied with the lower court's decision have the opportunity to proceed to a higher level court of hopefully more experienced and competent judges, to review their case and direct the lower court in line with their findings.

4. Predictably- and well-managed economies

The author was initially tempted to write "open market economies", but the success of China's very centrally managed economy and many European countries' success pursuing a mix of capitalism with a significant degree of regulation and redistribution limits the claim that free market economies are the most successful.

Much more important seems good management of the economy, and here is where politics are essential. All the wealth of a resource rich country / continent can be squandered in an ill-managed economy, especially where corruption is an issue. This can be seen in Venezuela and to varying degrees in various African countries, all suffering what has been called the "curse of oil"[6]. Greece and the potential accession country Albania ranking 69th and 83rd out of 176 prove that this is not only an emerging markets issue, as both countries rank behind Tunisia, Burkina Faso and Ghana[7]. This is as much a praise of these African countries, as it is a criticism of Greece and Albania. Especially Ghana is an often-overlooked star of the African continent, due to its friendly, peaceful and productive population. These qualities have made it one of the most important hubs in Africa for NGOs and international aid organisations aside from the country's other successes. How well small, resource poor countries can do, provided the economy is well managed and political decision making is predictable, is illustrated for example by Switzerland and Singapore.

5. Judicious, fair and consistent tax system

Contrary to some opinions, we regard a well-designed and applied tax system as an important asset for the investor, as it creates a stable state, able to fulfil its functions, without unduly overburdening the wealth creators in society, be they corporations or individuals. This is especially true for highly qualified staff and corporations, who are increasingly mobile and can relocate if it improves their tax position significantly[8].

Small deviations often go unnoticed, such as the UK's propensity to introduce retroactive tax legislation that covers events prior to the introduction of the legislation. The UK Government will often argue that the new legislation is not retrospective, but only retroactive, being 'legislation [that] imposes a tax charge on income arising or a gain realised after the date when the legislation comes in to force, but that income or gain arises from transactions entered in to (or at least commenced) before the legislation'.

One example is the removal of interest deductibility for smaller landlords introduced in the 2015 Finance Act. A landlord may have purchased an asset with long-term debt prior to the introduction of this legislation and now find that his interest payments are not an allowable deduction (cost) for his tax calculation changing a cash-flow positive investment into a cash-flow negative one, while being tied into long-term finance.

While it is not uncommon for tax legislation to change the tax treatment with immediate effect, the combination of a lack of prior public debate and of disallowing interest, which is treated as a legitimate expense in most other cases and this prohibition concerning an asset class that is typically invested in and financed for the long term does not inspire great confidence in the predictability of taxation and the decision makers.

For the avoidance of doubt, this is not applicable to our institutional clients, but sits uncomfortably close to their core business and interests. Plus, in the event of a Corbyn government coming to power, we predict wide-ranging changes to the current tax system increasing the tax rates to high earning individuals and corporates, further than the benign language of the Labour Manifesto 2017[9] indicates.

6. Stable population (including controlled migration) supportive of the existing political system and status quo

A population's stability in size, make-up, education, support of the government and its policies, etc. is the stabilising or destabilising foundation upon which a state rests.

Nowadays, migration plays a huge role and depending on who comes and goes and in what quantities societies benefit or suffer. Many cities and towns in former Eastern Germany have seen their population dwindle, with the young and best educated the most prone to departure in search of career and opportunities. The result for these communities and the remaining population was dire, leading to vast depopulated areas, void of economic energy and without the critical mass that a functioning infrastructure requires. In extreme cases the German government now offers financial support for the deconstruction of the remaining buildings in these areas.

On the other hand, the influx of predominantly skilled, hard-working, happily integrating, multilingual international staff helps cities like London (8.61m inhabitants in 2000 to 10.31m in 2015), Sydney (4.05m inhabitants in 2000 to 4.51m in 2015)[10]etc. keep an edge in international trade, skills and investment attractivity. These connections and skills base make them recognisable as gateway cities, favoured for investment as they enjoy a virtuous cycle of skills attracting new, well-paying employers, which in turn attract further skilled new arrivals.

International mobility has winners and losers. Where countries export their best and brightest employment-aged citizens in large numbers, the departure country loses expensively educated and productive human capital and the arrival countries gain these valuable economical assets. Greece, for example, suffered a significant brain drain as a result of the economic situation during and after the Greek debt crisis, when many highly skilled Greeks left for other countries, where a stronger economy allowed them to fulfil their potential. The opposite is of course true, where countries export the economically unproductive, ill-educated, criminals (Mafias and drug cartels operate globally) etc. or individuals disruptive to their host society including an unwillingness to integrate. In that case the recipient country suffers and the "exporting" country benefits from externalising their problems. In addition, funding terror groups is considered part of external policy in some countries, the negative impact on another country is seen in these states as a benefit.

The cost to the recipient country can be huge. In 2003/4 the UK Home office tried to quantify the cost of crime by offence in a detailed research. Despite probably significantly underestimating the immediate and follow on cost (e.g. the cost of long-term prison sentences and the physical and emotional suffering of victims, relatives and wider community), the cost in 2003 prices ranged from £510 for an attempted vehicle theft to £8,852 for a wounding and £1.459m for a homicide[11]. The cost of terror attacks was not included, as in 2003 these were not a regular feature in Western Europe. Given the above, it stands to reason that the cost for such an attack typically would go into the tens or possibly hundreds of millions, depending on the scale, the cost of prevention and the aftermath of the terrorist atrocity. While unable to account for the true human cost, this is an attempt of scientifically quantifying the cost of crime.

Migration, like so many things, has not only an economic element to it, which economists often forget. Social, political, housing, safety and other concerns need to be taken into account. This has two sides; a) the contribution (positive or negative) made by the foreigners and their willingness to integrate into their host countries, and b) the existing population's ability and willingness to recognise the contribution and accept and integrate foreigners.

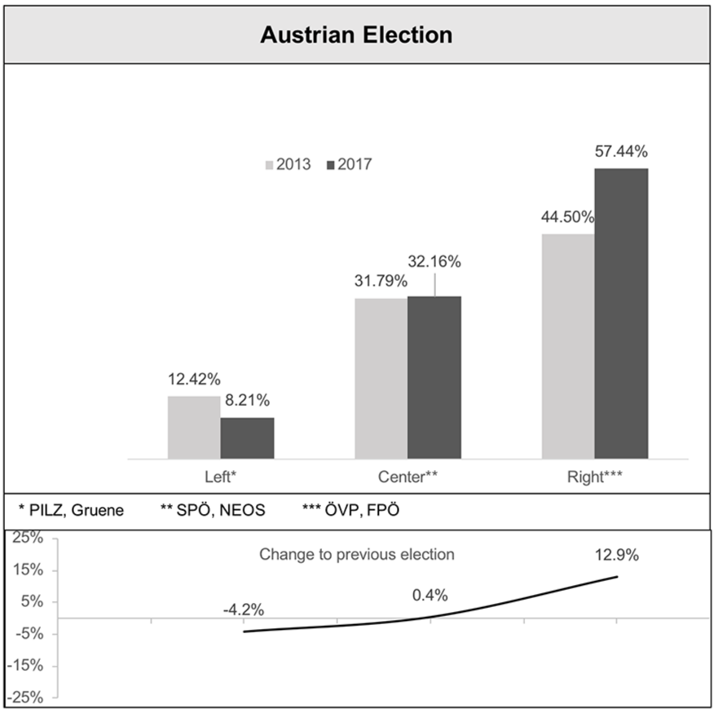
Foreigners in large numbers bring and maintain their own culture, religion, advantages and disadvantages and way of doing things, becoming an asset or a liability for the host country. How long lasting such differences can be, can be seen by looking at the German cities of Brazil, many of which still have a strong German feel, with German being spoken widely. All this more than a century after their foundation. The same applies to Chinatowns and may other minority communities all over the world. The impact that foreigners have depends on the immigrants' culture, religion, education and the compatibility of these with that of their host country, and most importantly on the foreigners' willingness to integrate peacefully into their host country. The above-average success of Chinese[12] and Indian[13] immigrant communities in the USA is widely documented as an all-round positive example for migration, where both individuals and host country reap significant benefits. The recent large-scale Muslim immigration into Europe is proving much more difficult for the European host countries, including some of the already present, well-integrated and enlightened Muslims, who do not take those parts[14] of the Koran which encourage intolerance and violence literally and, to their understandable dismay, find themselves tarred with the same brush as their un-enlightened co-religionists. This causes undercurrents of tension between various parts of the population and undermines societal cohesion. In Germany, this migrant inflow led to a surge in Islam-inspired terrorism, rising violent crime[15], a deteriorating security situation for women[16] and increased anti-Semitic[17] and homophobic attacks.

Drastic changes of population can have an impact on societal cohesion and risk plunging the host country into the same difficulties prevalent in the migrants' original home countries. Given the significantly different birth rates, many immigrant communities are likely to grow disproportionally relative to the native population, potentially exacerbating the divisions. Even after the horrors of World War II and despite the comparatively small religious and cultural differences within Europe, those differences still have led to a significant amount of strife between groups which had a very high level of similarity, e.g. the Troubles in Northern Ireland, the Basque Separatism and the catastrophic implosion of the former Yugoslavia. The larger the differences, the bigger the risk of parallel societies which fail to integrate and at some point, turn on each other. Culture, tolerance and willingness to integrate are key.

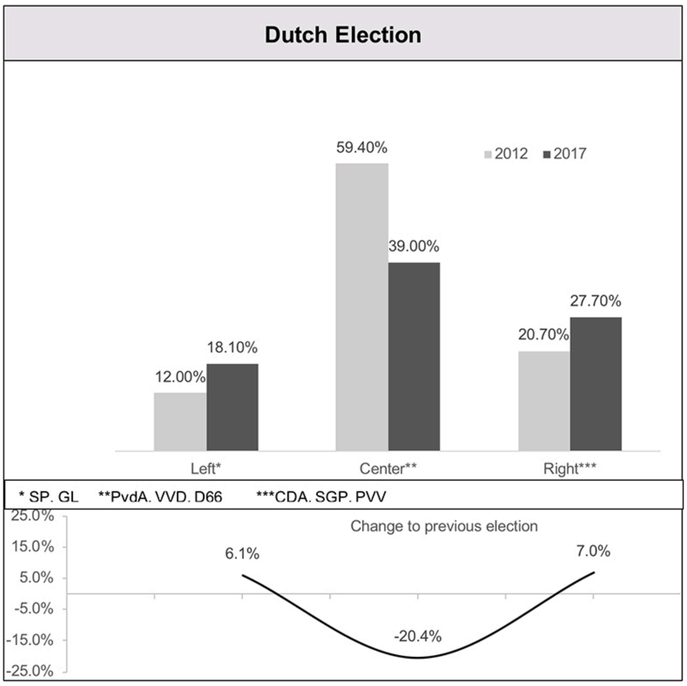
Changes of population, whether caused by migration, mortality and birth rates etc. change the make-up of society and thereby influence economics, politics etc. Large scale immigration also seems to polarise societies, which is not good news for cohesion and continued support of the existing political system and status quo. Such reduced support allows new entrants into the political arena, which, as new entrants, are by definition, an unknown quantity thereby increasing political risk and divert the political discussion and funds away from other economic and social issues.

7. A political class and environment focussed on achieving/maintaining the above

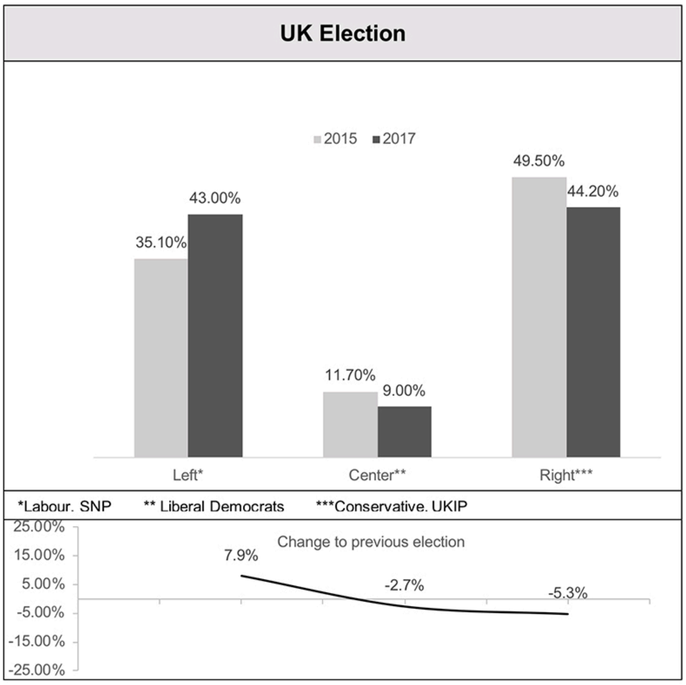
The poor performance of what was previously called the “People’s Parties” or “Parties of the Middle” throughout Europe is a clear sign that European electorates are not satisfied with their leaders. All countries below saw a significant move from the centre to the left and right. The move to the right was caused by dissatisfaction with how politicians handled the migrant crisis of 2015 and the subsequent effects. It also showed a significant dissatisfaction with the political class in general and was in part a vote protesting against the “Facebook politicians” who, like teenagers, seem predominantly focussed on likes and approval ratings and so consumed by their political correctness that they are unwilling to say anything that could upset anyone, even if their leadership role would require them to do so.



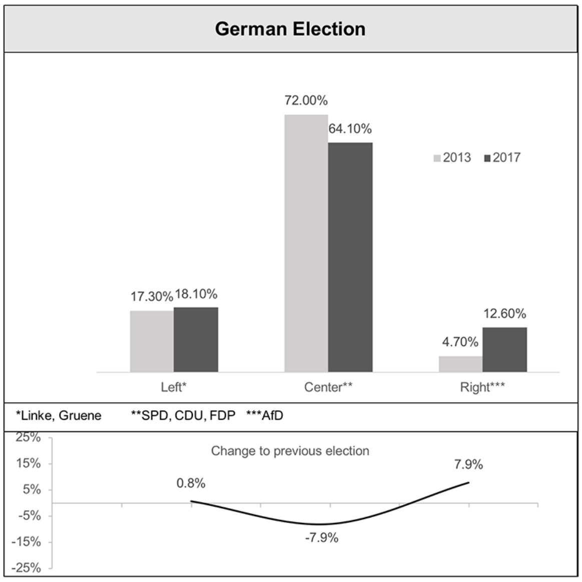
(Source: www.nationalratswahl.at)



(Source: www.economist.com)



(Source: www.bbc.co.uk)



(Source: www.bundestagswahl-2017.com)

The long-term investor should analyse the political parties and their ability and willingness to maintain an investment-friendly environment, rather than pursue politics expedient for short-term approval ratings. For Europe in particular, the increasing willingness to delegate difficult decisions to a government far removed from the people it governs[18] (i.e. Brussels) creates divergences and tension between electorate and legislative powers. This poses additional political risk, as at present voters can remove their incumbent government at the next election, but this makes no difference if the government has outsourced the responsibility for the contentious issue to the European Parliament.

Summary

Political risk is becoming more important as an element of overall investment risk. The above examples show that this risk is not confined to emerging countries or certain geographies.

Investors should monitor political risk in the same way they monitor market risk and treat a significant deterioration of the above parameters as an indication to hold or decrease their exposure, keeping in mind that while property market risk typically has a cyclical nature and foreseeable cycle length, neither of these apply to political risk. Once a certain threshold in politics is crossed, the situation may not return to the previous normal, or may take decades to achieve some level of normalisation (see Russia in the early 20th century, Germany in the 1930's, Cuba, Venezuela, Yugoslavia etc.).

As a result, the investment horizon must be in line with the investor's ability to predict future developments accurately. Ideally, it should be equal to a term for which politicians can be trusted to maintain the above criteria, plus the required term for marketing and disposal.

Just like volatile rental- and yield-environments favour a "dip in and get out" approach, so do all unstable countries, if they are investable in the first place.

Currently unstable countries or countries with increasing political risk are therefore not suitable for very long-term investment strategies and hence unsuitable for certain investor types, like inter-generational investing family offices or liability matching assets with the intention to be held for decades.

In short: The investor's (political) risk appetite and desired hold period should not only define which asset class, strategy and location, but also which country the investor selects.

[1] Savills Research: London Office Outlook, January 2018.

[2] https://en.portal.santandertrade.com/establish-overseas/turkey/foreign-investment

FDI in Figures

According to the UNCTAD 2017 World Investment Report, Turkey was the second largest recipient of FDI in West Asia, behind Israel.

After reaching a record high (USD 22 billion) in 2007, FDI flows to Turkey have decreased. FDI reached USD 17.5 billion in 2015 and dropped to USD 12.1 billion in 2016 according to Turkish Ministry of Economy (2017). The factors hindering FDI development include political instability (an attempted coup d'état took place in 2016 claiming many lives), the weak currency, inflation, the proximity to conflicts in the Middle East as well as administrative measures taken against the Gulenists for their alleged implication in the coup.

The countries of the European Union, the Gulf States and the United States are among the main investors in Turkey.

[3] Labour Manifesto "For the many not the few" 2017, p. 19 "Widening ownership of our economy".

[4] Washington Post 06/02/2018.

[5] http://www.latimes.com/world/middleeast/la-fg-turkey-constitutional-crisis-20180129-story.html "Imagine the chaos if lower courts refused to abide by a Supreme Court ruling. That's happening in Turkey".

[6] "The curse of oil: The paradox of plenty" - The Economist, Dec 2005 quoting a 1995 study by Jeffrey Sachs, now of Columbia University in New York, that the resource-rich countries grow more slowly than other poor countries — even after such variables as initial per capita income and trade policies are taken into account.

[7] Corruption Perceptions Index – Transparency.org 25/01/2017. https://www.transparency.org/news/feature/corruption_perceptions_index_2016

[8] "Sweden Wins EU Backing for Lower Taxes on Startup Stock Options" - Bloomberg 29 June 2017.

[9] Labour Manifesto "For the many not the few" 2017, "A fair taxation system" p.9.

[10] http://worldpopulationreview.com

[11] "The economic and social costs of crime against individuals and households 2003/04", UK Home Office, 2005 p.7.

[12] "Explaining Asian Americans' academic advantage over whites", PNAS 2014 June, http://www.pnas.org/content/111/23/8416

[13] "A model minority: How Indians triumphed in America", Economist 26/11/2016 and "The Other One Percent: Indians in America." By Sanjoy Chakravorty, Devesh Kapur and Nirvikar Singh Vol. 40, No. 2 (2001), pp. 48-60.

[14] See a.o. Sura 2 "The Cow" berating the Jews for the sin of the Golden Calf, and Sura 8 "The Spoils" & 9 "Repentance" both dealing with waging war on non-believers.

[15] Die Welt, 23.04.2017 "Zahl der tatverdaechtigen Zuwanderer steigt um 52,7%" – Auslaender praegen organisierte Kriminalitaet in Deutschland : "Wie aus der PKS hervorgeht, gab es [2016] insgesamt 616.230 auslaendische Tatverdaechtige. Die Zuwanderer haben daran einen ueberdurchschnittlich grossen Anteil, naemlich mit 174.438 mehr al sein Viertel….

[16] Berlin and other cities set up special safety zones for women at the new year celebrations 2017, following the mass sexual attacks by migrants during the previous year's celebrations.

[17] Stephan Harbarth MdB CDU "We must resolutely confront the anti-Semitism of migrants with an Arab background and from African Countries…".

[18] Koalitionsvertrag zwischen CDU, CSU SPD 2018: Europapolitische Verantwortung Deutschlands p.109.

As always we would be delighted to hear from you at london@afadvisory.com or @AFAdvisory if we can be of any assistance or if you have any comments regarding this newsletter.

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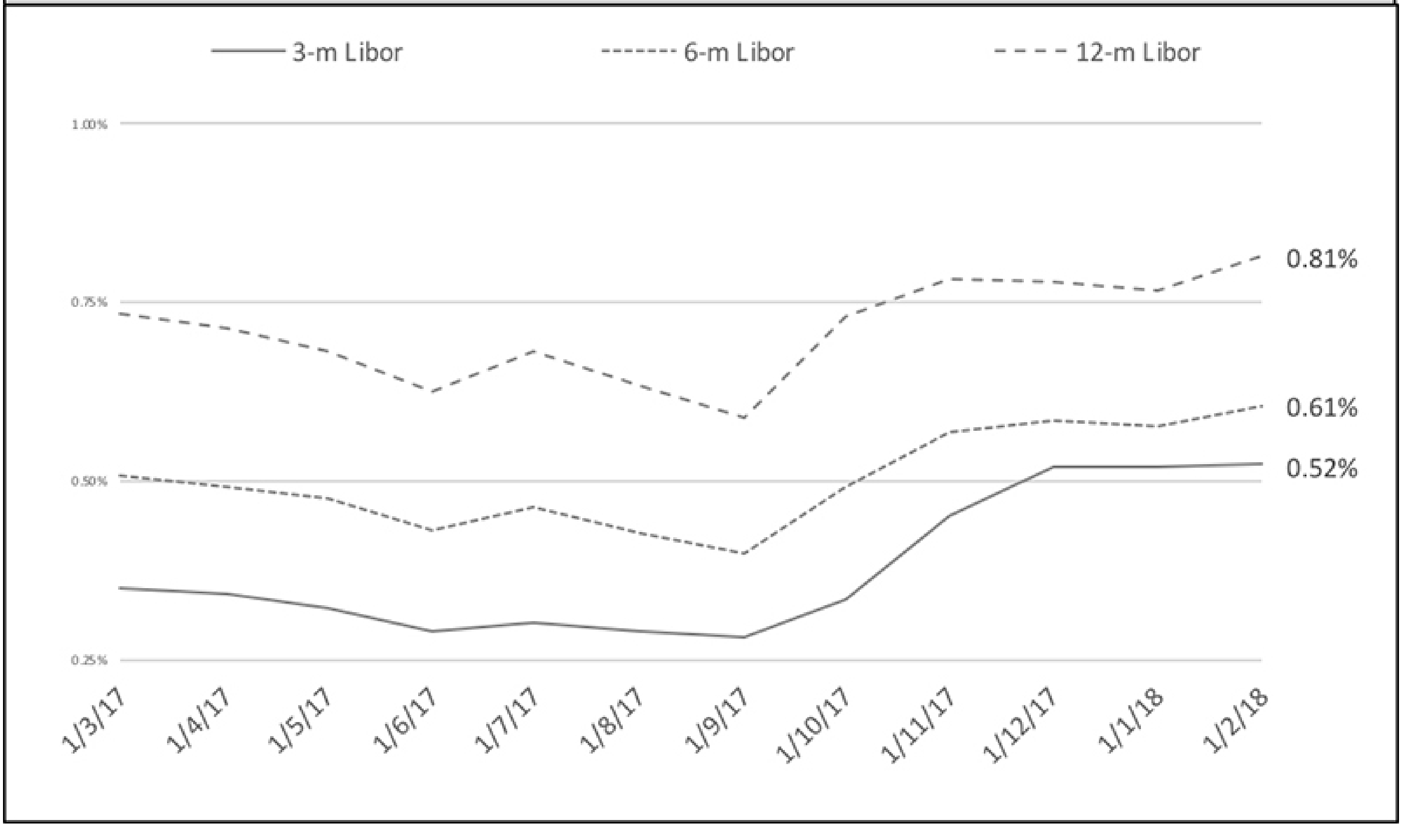
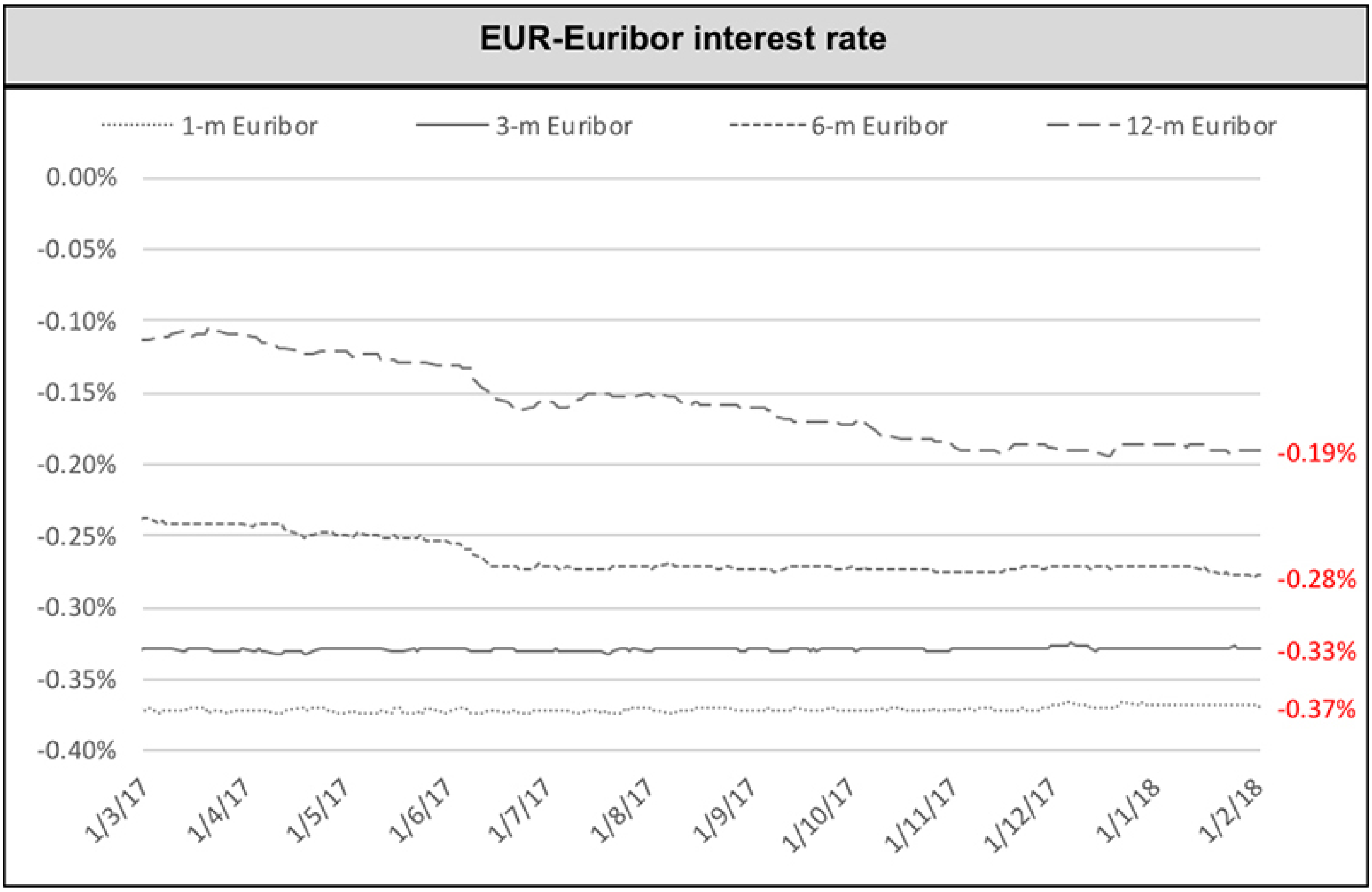
REAL ESTATE DEBT & EQUITY

MARKET DATA

GBP-Libor interest rate




EUR-Euribor interest rate
1-m Euribor
3-m Euribor
6-m Euribor
12-m Euribor
0.00%
-0.05%
-0.10%
-0.15%
-0.20%
-0.25%
-0.30%
-0.35%
-0.40%
-0.19%
-0.28%
-0.33%
-0.37%
1/3/17
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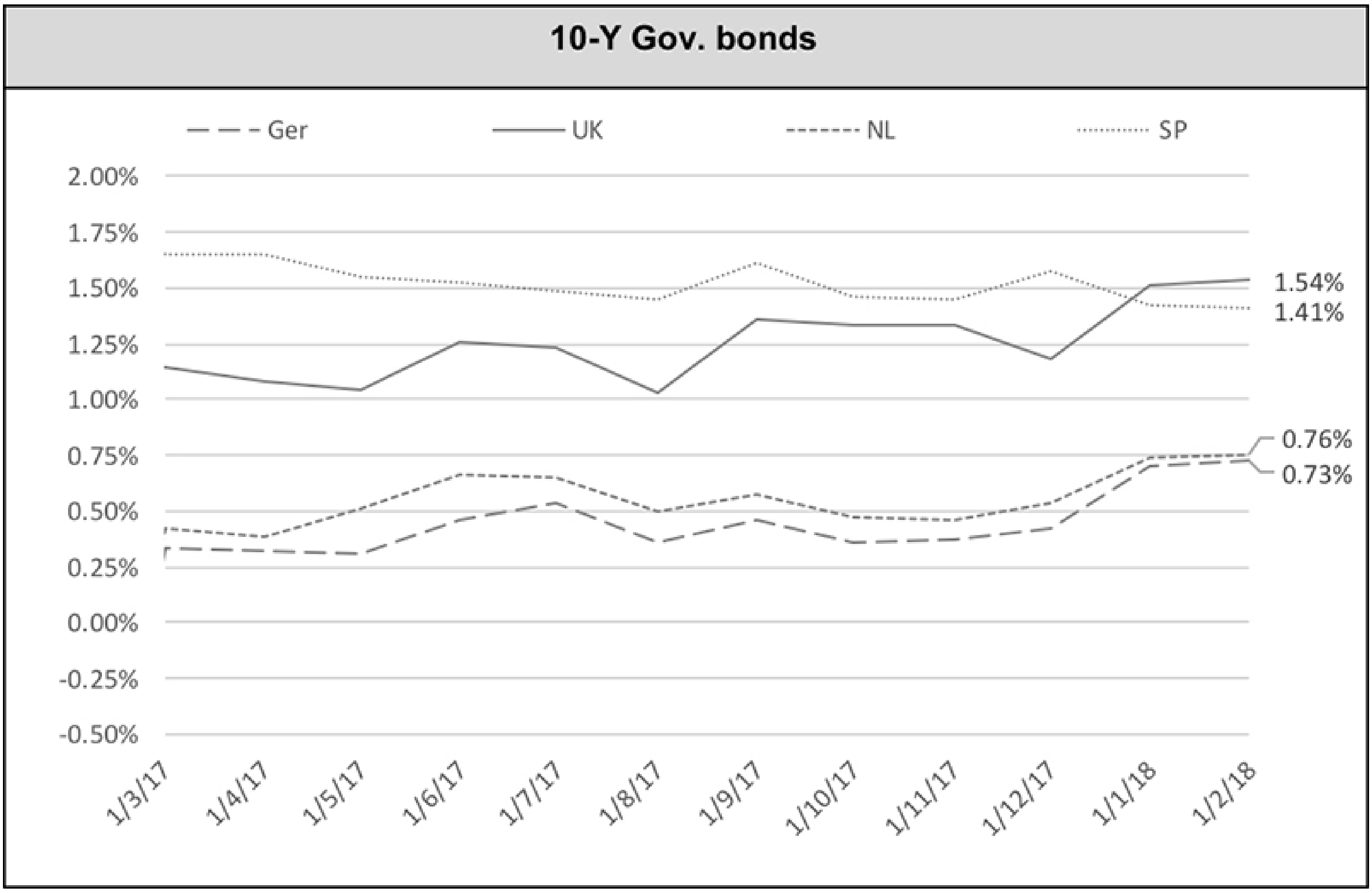
10-Y Gov. bonds
Ger
UK
NL
SP
2.00%
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1.00%
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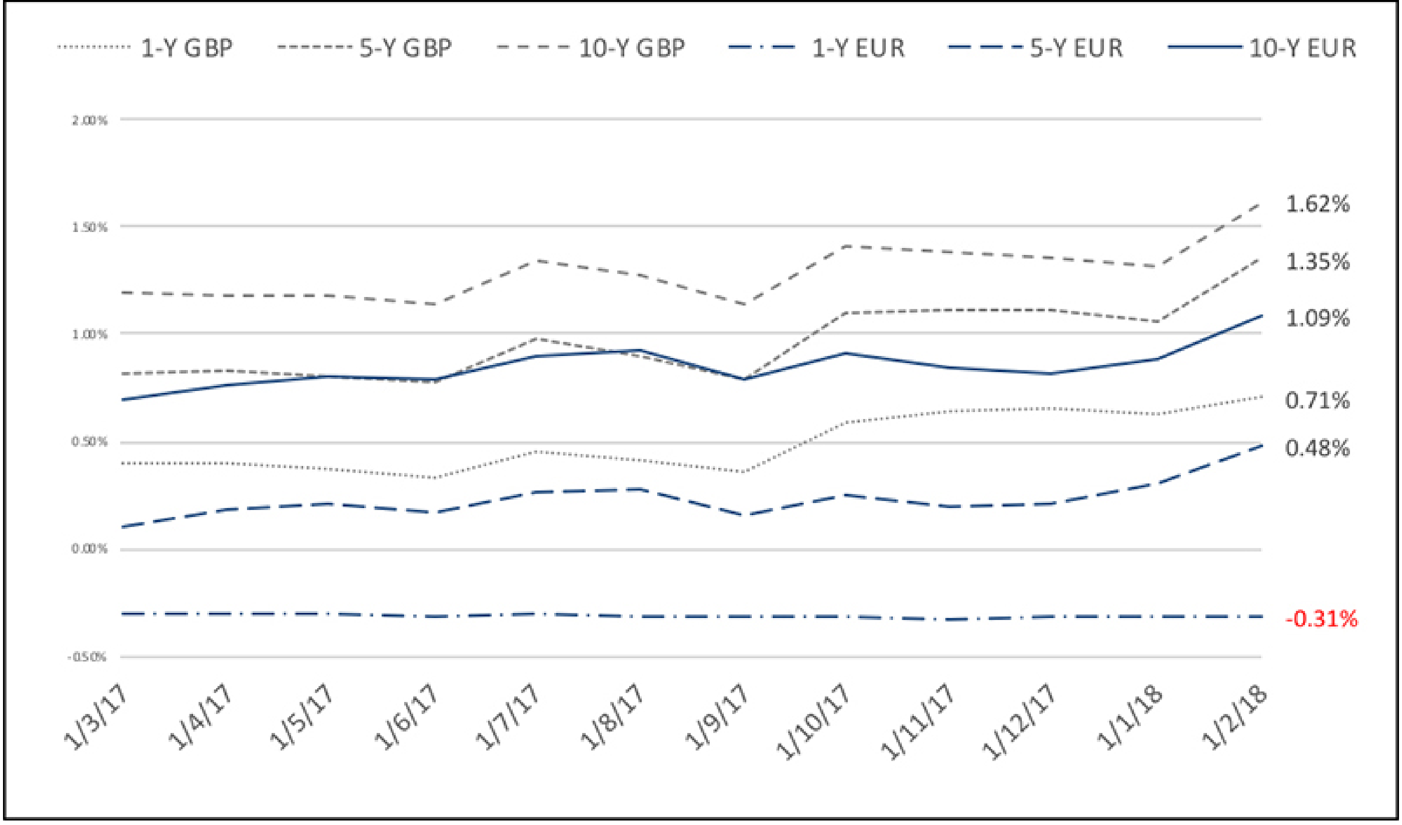
1/2/18

SWAP rates past 12 months



Exchange rate	Rate	52-W high	52-W low	1-Y change
EUR/USD	1.23	1.25	1.05	15.36%
GBP/USD	1.40	1.43	1.21	10.65%
CNY/USD	0.16	0.144	0.16	9.61%
EUR/GBP	0.89	0.93	0.83	4.27%

Index	Symbol	Rate	52-W high	52-W low
FTSE EPRA/NAREIT Eurozone Index	EPEU	2,470	2,733	2,287
FTSE EPRA/NAREIT UK Index	ELUK	1,697	1,865	1,660
STOXX® Europe 600 REITs	S8670R	100	111	99
STOXX® Europe 600 Real Estate	SX86GR	172	189	164
Dow Jones Europe Select REIT Index	DWEURT	1,119	1,224	905
DJ Europe Select Real Estate Securities Index	DWEURS	3,264	3,558	2,708

	Unemployment %		GDP growth QoQ %		Inflation YoY %	
Country	Q3 2017	Q4 2017	Q2 2017	Q3 2017	Q3 2017	Q4 2017
UK	4.3	4.3	0.3	0.4	2.8	3.0
Germany	3.7	3.7	0.1	0.4	1.8	1.7
Spain	16.4	16.6	0.9	0.8	1.6	1.5
Netherlands	4.7	4.4	1.5	0.4	1.4	1.4

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