Morgan Stanley

INVESTMENT MANAGEMENT

2017 Commercial Real Estate Outlook

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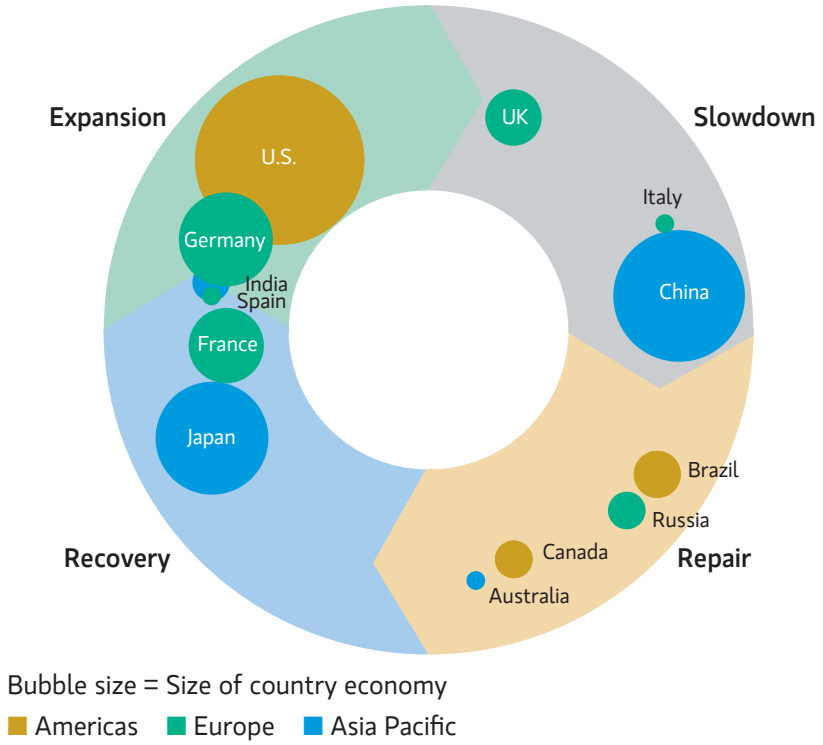
The global macroeconomic landscape is undergoing a shift away from monetary policy, deflation and a low growth environment towards fiscal stimulus, reflation and a higher growth environment. While growth is expected to be more broad-based, interest rates are likely to diverge, currency movements may remain dramatic and geopolitical event risk will be heightened. Against this backdrop, regional economies face asynchronous growth drivers and unique challenges and, as a result, property and capital markets vary widely. Additionally, structural trends, such as demographic and technology shifts, continue to influence growth patterns and investment strategies. Morgan Stanley Real Estate Investing (MSREI) believes these factors, combined with unprecedented volatility and uncertainty in the market, may create a potentially favorable environment for real estate investing globally.

Macroeconomic Environment

The global recovery, in our view, is likely to gain momentum in 2017 and push growth back up towards its historical average on the back of faster growth in the United States and rebounding emerging market momentum resulting from the recovery in

DISPLAY 1
Major Economies at Various Stages in the Cycle[1]



Source: Moody's Analytics, Morgan Stanley Research, MSREI

commodity prices. Since the beginning of the year, several countries have changed positions within our economic cycle framework, with U.S. growth now expected to accelerate versus moderate, the UK and Italy slowing and Russia and Brazil "repairing". Stronger global growth will increase capacity utilization and lift employment levels towards or above full employment, spurring wage growth. Inflation pressures are expected to increase in some countries (such as the United States and United Kingdom) as a result of higher commodity prices and increased fiscal spending, resulting in divergent interest rate policies. While growth remains more balanced, material risks remain from late cycle fiscal stimulus, faster Fed rate hikes and a broad globalization backlash.

The United States is expected to enter a period of accelerating economic growth due to a combination of fiscal stimulus (tax cuts, infrastructure spending), repatriation and looser regulation, assuming the new administration's trade policies are somewhat moderated.[2] Stimulating the economy late cycle may trigger a more aggressive monetary policy response and could lead to tighter financial conditions. In Europe, although Brexit has not dented growth yet, political uncertainty remains elevated contributing to moderate economic growth over the next couple of years. An extension of quantitative easing plus expanded fiscal policy should help support the economy. In the U.K., while near-term growth remains resilient post-referendum, a slowdown is expected, driven by a decline in investment and by slower consumer spending growth as a result of hiring caution and higher inflation. In Japan, growth is expected to accelerate supported by fiscal policy and a global rebound. Inflation is likely to re-accelerate as the yen weakens and oil stabilizes, contributing to higher corporate profits. Growth in China is expected to continue to moderate due to a slowdown in the housing sector which should be partly offset by ongoing fiscal support, while India's economic recovery is becoming more broad-based, gaining momentum from strong demographic tailwinds.

Structural Trends

Structural trends continue to play an increasingly important role in economic growth patterns and investment strategies around the world. Demographic trends, including aging populations, the rise of millennials, the growing middle class and urbanization are contributing to different living, spending and working preferences which are creating attractive opportunities in the residential, retail and office sectors.

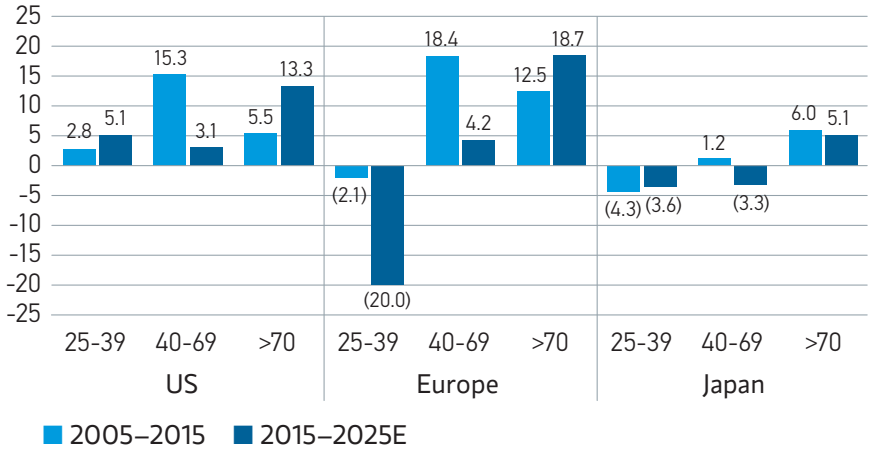
Technology advancements and mobility trends are continuing to disrupt traditional real estate sectors. E-commerce is blurring the lines between retail and logistics and contributing to a marked bifurcation in the performance of shopping centers; increased levels of automation are creating efficiencies in traditional office-using sectors, while big data and enhanced analytics are creating opportunities for landlords to offer tailored products and outperform their peers. While technology has helped improve global interconnectivity, rising protectionism threatens to undo some of the benefits of globalization (which had already started to stall pre-election) and potentially hurt countries more reliant on trade and immigration.

[1] The economic cycle positioning framework is based on a qualitative assessment of where each economy sits relative to its economic cycle.
[2] Source: Morgan Stanley Research , November 2016

DISPLAY 2

Aging Demographics

2005-2025E, Change in Population by Age Cohort
Change in Population, MM people

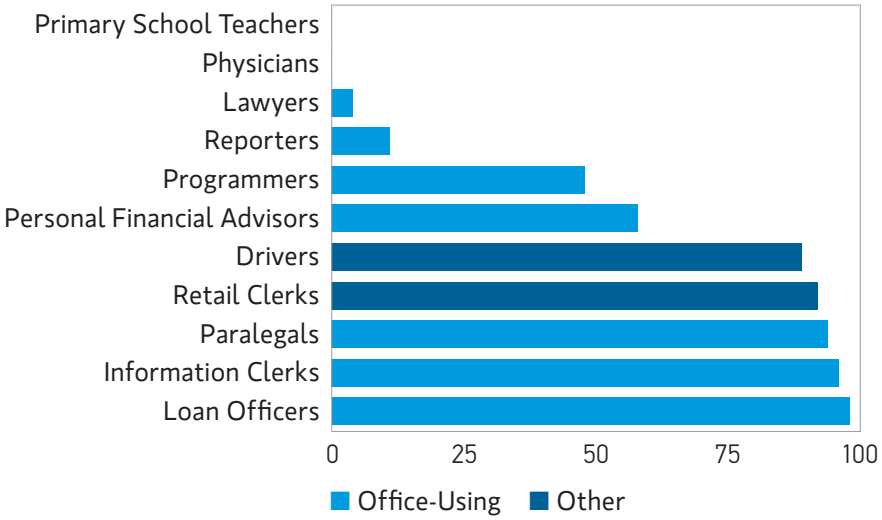


Source: UN Population Division, World Population Prospects, 2015 Revision

DISPLAY 3

Increasing Digitalization of Jobs Typically Unlocks New Productivity

Probability of a Job Becoming Automatable, %



Source: University of Oxford, Morgan Stanley Research, as of August 2016

Real Estate Implications

The combination of an improving but divergent macro environment, real estate markets at different cyclical points (see Market Cycle chart on page 4), heightened geopolitical risk and shifting structural trends will likely create opportunities for attractive risk adjusted returns across all regions. Coming out of the global financial crisis, real estate has benefited from the economic recovery cycle and declining interest rates in most parts of the developed world, supporting attractive returns driven in large part by cap rate compression. As a result, current valuation levels in most sectors are elevated and future returns should be expected to moderate. However, as the full impact of the US election result, the UK's Brexit vote and other European political events rolls through the global property markets, significant dislocations may create the potential for attractive risk-adjusted returns.

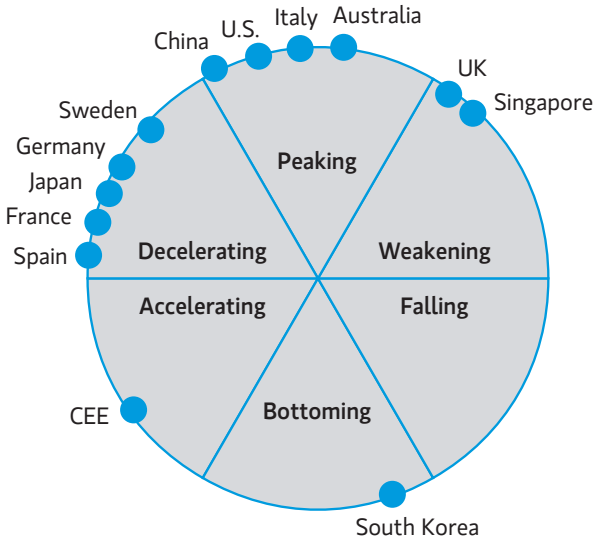
In the United States, the investing environment is likely to shift from a "lower growth, lower rates, for longer" setting to a "higher growth, higher rates" backdrop, at least in the near term. While higher rates have the potential to lead to cap rate expansion, the current expectation is that stronger economic growth may translate into stronger rent and NOI growth (given supply is also in-check), which in turn should support real estate values. Additionally, the spread between cap rates and risk free rates remains above the historical average in most markets, potentially providing a cushion against interest rate rises.

MSREI believes that slightly stronger near-term economic growth may create opportunities to reposition assets to take advantage of potentially higher rent growth, given existing strong occupancy levels. On the other hand, tighter financial conditions resulting from higher interest rates and a stronger USD may lead to pockets of illiquidity and distress, potentially creating attractive recapitalization opportunities in sectors that are facing over-supply (such as luxury residential and hotels) or softening

DISPLAY 4

Market Cycle[3]

Office Sector

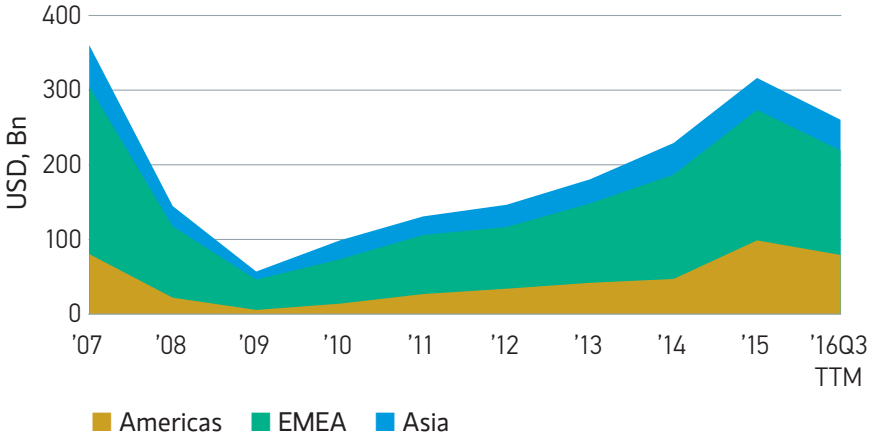


Source: MSREI Strategy, data as of 3Q 2016

DISPLAY 5

Global Capital Flows

Cross Border Investment



Source: Real Capital Analytics, MSREI Strategy, data as of 3Q 2016

demand (e.g., commodity and technology markets). Additionally, higher retail sales resulting from stronger economic growth, proposed tax cuts, higher wages and increased consumer confidence, coupled with increasing e-commerce penetration, may create opportunities to develop modern fulfilment centers targeting e-commerce tenants looking to satisfy last mile delivery requirements. Lastly, the housing sector may present a compelling opportunity based on a housing shortage (inventory of existing homes for sale is at its lowest level since 2000), especially in the first-home buyer segment, in conjunction with rising demand driven by demographics (1MM+ annual household formations, shifting preferences of millennials) and an improving economy.

In the UK and Europe, MSREI believes the expected slowdown in capital flows, together with a lower growth environment as a result of Brexit, should continue to support defensive cash flow strategies that offer investors healthy income protection. In Europe, bank deleveraging in Italy and under-capitalized hotel owners in several European markets (e.g., Paris) may create opportunities to target higher quality assets in need of investment, asset management or both. In the U.K., moderate levels of distress in the London high-end residential market should continue to provide attractive recapitalization opportunities. Similarly, the London office sector is likely to see further price declines and a limited universe of buyers, potentially offering attractive acquisition opportunities at a reduced basis. MSREI also believes that faster-growth Central and Eastern European countries could offer opportunities to reposition high quality retail and office assets in prime locations taking advantage of the rental recovery, growing institutional liquidity and yield

[3] The market cycle positioning framework is the outcome of the use of an internal tool being developed by MSREI based on a consistent set of real estate metrics available on a country-by country basis. It is aimed to help identify drivers of market performance, market positioning relative to prior cyclical peaks and troughs, turning points and implications for investing strategies. It is updated on a quarterly basis in line with the release of macroeconomic and commercial real estate data. The tool uses a mix of real estate fundamentals and capital markets metrics that are generally available in applicable countries (including rent, occupancy, cap rates and spreads and liquidity and values metrics). The majority of the metrics are based on "actuals", versus relying on forecast data. Note that other outcomes could result if different inputs or assumptions are made. The market cycle positioning constitutes a "forward looking statement." Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statement.

spreads between primary and secondary cities that may widen following Brexit. Lastly, similar to the U.S., there may be attractive development opportunities in the housing sector in countries such as Spain, where pricing has just begun to recover following the dramatic sell off during the financial crisis (pricing is down 30 – 70% from peak levels depending on the market, and new home construction is down 95% from peak levels).

In Asia, MSREI continues to believe in the long-term growth prospects for the region, particularly in markets such as China and India fueled by increased urbanization, middle class formation and service sector growth. Development partnerships in these growth markets targeting sectors aligned with the consumer and service sector, such as retail, logistics and office will likely lead to attractive returns, subject to hedging costs. In Japan, interest rate differentials to the U.S. may widen which could modestly weaken the yen. This would provide a boost to exports and tourism and support to the hotel and retail sectors. While pricing in the developed Asian markets (e.g., Japan and Australia) has accelerated significantly, office rental growth remains relatively strong offering potentially attractive value creation opportunities. Specifically, office rent levels in Japan, Singapore, Australia and Korea remain below prior peak levels, creating potential opportunities to reposition or lease-up Class A-/B+ assets to take advantage of the rent recovery. Additionally, e-commerce penetration and growth rates are higher in Asia than the U.S. and Europe, creating development opportunities in the logistics sector. Lastly, pockets of distress are beginning to emerge in trade- and commodities-oriented markets such as Singapore and Perth, where pricing is beginning to adjust to the decline in fundamentals. Similar to select residential markets in the U.S. and U.K., distress is also beginning to emerge in Sydney and Melbourne as the government attempts to slow down the housing market, creating potential recapitalization opportunities as developers face funding gaps.

DISPLAY 6

Regional Market Themes

U.S.

- Post election, interest rates expected to normalize at a faster pace
- Volatility = tighter financing conditions
- New policy agenda could spur stronger growth, improving fundamentals given new supply remains muted in most markets
- Capital flows robust, yields stabilizing
- Pricing divergence between prime and non-prime continues

EUROPE

- Post Brexit, growth expected to moderate
- Geopolitical tensions heightened leading to increased uncertainty and volatility
- ECB and BoE QE programs continuing
- Capital flows moderating, pockets of illiquidity may emerge
- Yield spreads between core and non-core markets still exist

ASIA

- Japan: Rent recovery accelerating despite slow growth economy
- Australia: GDP growth steady, property fundamentals remain robust in Sydney / Melbourne
- China: Heightened volatility as economy transitions and slows. Debt levels remain a concern

Targeted Investment Strategies by Region

U.S.

- Value-add / Repositionings
- Select new developments
- Recapitalizations

EUROPE

- Defensive / cash flow investments
- Core in non-core markets
- Recapitalization / distressed opportunities
- Value-add / Repositionings

ASIA

Developed Markets
- Value-add / Repositionings
- Defensive / cash flow investments

Growth Markets
- Development partnerships

Conclusion

Compared to the last few years, MSREI expects that the investing environment during the next several years will likely produce a different set of investment opportunities across countries and sectors. MSREI believes asynchronous growth drivers, different market cycle positionings and relative price inefficiencies caused by divergent interest rate policies may continue to provide attractive risk-adjusted returns across the United States, Europe and Asia.

Important Disclosures

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