Real Estate

We recommend an at benchmark allocation to Real Estate for 2021, with an emphasis on opportunistic and value-add private equity real estate ('PERE') investments which we believe will continue to offer better risk-adjusted returns with a greater opportunity for generating alpha compared to core property. For conservative investors, we favour core-plus investments over core, as the value-add component provides an additional margin of safety for skilled managers.

Real estate plays an important role in client portfolios given the income yield, the potential hedge against inflation, and the opportunity to generate incremental returns by repositioning assets. In 2021, we continue to favour managers with deep local expertise, who can generate proprietary deal flow, and are vertically integrated, i.e. those with in-house investment, asset management and development expertise. We find this asset-focused approach can reliably generate strong returns in any market environment. We believe there are several sectors, including logistics and multifamily, which will be resilient in the post-COVID environment and in which there are clear value-add opportunities for specialist managers through modernising assets.

The distressed opportunity set, while not yet widespread, has increased over the past year. We expect to be active on a selective basis and are focused on strategies targeting high-quality, well-located assets with short-term cash flow challenges, such as new constructions with upcoming debt repayments, or forced sales from open-end funds with major redemptions. However, we are also mindful that there may be sectors of real estate which are facing increased uncertainty given the potential medium to long-term effect of COVID-19 on sectors such as urban office and hotels catering to business travel.

Asset Class Definition

Core property is typically characterised by high-quality, well-located properties with long-term, in-place leases to tenants with good credit ratings. These assets offer stable, predictable income with modest price appreciation relying primarily on rent growth. There is less dispersion of returns within core property than there is within PERE; there tend to be more buyers for properties that provide secure long-term income streams resulting in efficient pricing. As a result, it is difficult to generate meaningful alpha in the asset class. While core property is broadly categorised as a liquid asset class, there is an inherent liquidity mismatch between underlying properties and the open-ended structure of core property funds which typically offer liquidity only quarterly. To address this, there is a meaningful bid-ask spread for funds in the UK and Europe (3%-7%) and queueing and gating mechanisms for funds in the US. To amortise these costs, investors should expect a holding period of five or more years, but over this time horizon, we favour strategies with greater potential for value-add.

Real estate investments trusts ("REITs") are another option for accessing core real estate. REITs offer exposure to professional management and a broad range of institutional real estate asset classes. However, REIT returns are generally dominated by equity beta over the short-to-medium term (<three years), with a rolling three-year beta of 0.8x to global equities.

PERE strategies typically target more complex situations which may require development, heavy refurbishment, conversion to an alternative use (e.g., office to residential), distressed debt or asset turnarounds. Unlike core property strategies, PERE strategies are typically more levered, and target returns of >12%. PERE strategies charge higher fees and include a performance fee component. PERE funds are typically closed-ended allowing managers to execute longer-term business plans without the prospect of fund redemptions.

Role in the Portfolio

Private equity real estate plays an important role in a multi-asset class portfolio, providing a contractual income stream, exposure to economic growth, inflation protection, and an alpha-generating opportunity that has a low correlation to other return streams. There can also be tax advantages to investing in real estate.[1] It is important to compare after-tax returns when considering the attractiveness of real estate vs. other asset classes.

We believe PERE is an attractive asset class for generating alpha. While real estate has become an increasingly institutional asset class, there remains considerable opportunity for skilled managers to add value in excess of market returns. Investors with asset management expertise can improve the operating profile of a property through increasing occupancy, driving rent increases, optimising tenant mix and lease length, and reducing costs. These opportunities usually arise from sub-optimal capital structures or underinvestment by previous owners.

For core property, we have a long-term expected return of 5.3%.[2] This is driven primarily by in-place income, as well as moderate capital appreciation in line with market levels. The 5.3% is comprised of c.4.5% income, c.2.0% for inflation, and c.1.2% in fees, transaction expenses and other frictional costs. We expect a 4% premium for PERE due the alpha opportunity afforded by the illiquid structure and higher risk tolerance. Adding an additional 1% of manager selection alpha suggests PERE offering a long-term expected return of 10.3%

1 Partners Capital are not a tax advisor. Tax treatment will depend on the individual circumstances of each client and is subject to change. Clients should consult their own tax advisors to understand the tax treatment of a product or investment.

2 This estimate of performance returns is based upon certain assumptions which should not be indicative of actual events that will occur. There is no assurance that the performance presented will be achieved. Please see important Disclaimers at the end of this material.

3 Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance. Please see important Disclaimers at the end of this material.

Golden Rules

We continue to hone our "golden rules" for investing in real estate as summarised below:

1. Maintain diversification by vintage, sector and geography;
2. Focus on quality assets but "build-to-core" rather than buy core – core assets tend to be priced efficiently, so target assets with the potential to become core, but with some existing operational, physical or financial impairment, which can be addressed during your ownership;
3. Focus on basis – buy at a discount to replacement cost and avoid greenfield development (except in exceptional circumstances);
4. Avoid excessive use of leverage which can lead to capital impairment;
5. Target liquid markets, be wary of secondary markets and avoid tertiary and emerging markets;
6. Focus on vertically-integrated managers with excellent local knowledge and operational capabilities;
7. Taxes must be considered for each investor – real estate can have substantial tax benefits for individual investors, but also significant tax headwinds for global investors.[3]

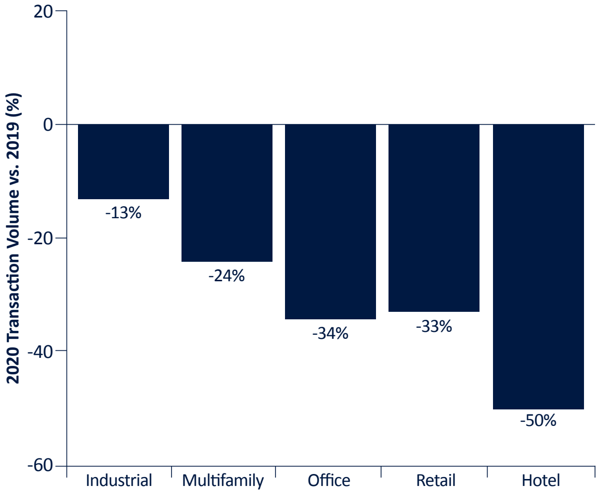
Market Overview

COVID-19 and the associated shutdowns have had a direct impact on real estate. The sectors most negatively affected in the short-term have been hospitality and retail, while the longer-term outlook for office has become uncertain. Of the major sectors, multifamily has been least impacted, while other sectors such as industrials, life sciences, and data centres have been beneficiaries, as pre-existing tailwinds in those sectors accelerated in the COVID environment.

Amidst the significant uncertainty around future tenant demand, real estate transaction volumes fell sharply, ranging from -13% for industrials to -50% for hotels. Cap rate spreads (measured as cap rates minus government bond yields) have widened in the US and Europe driven by a decline in government bond yields and rising cap rates.

Exhibit 1

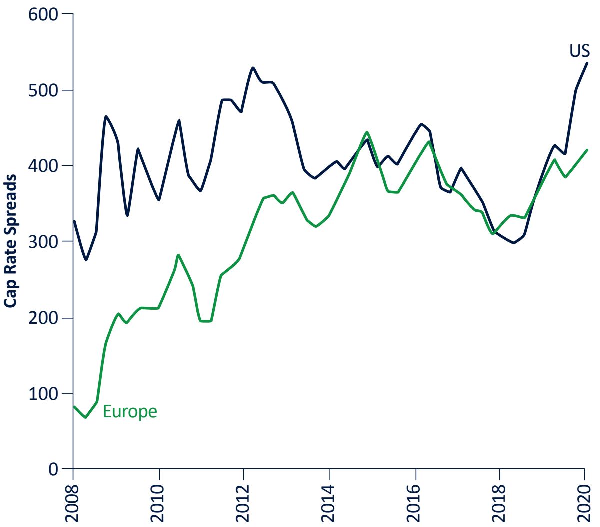
Real estate transaction volume declined significantly in 2020



Source: *JLL*

Exhibit 2

Real estate risk premia (measured as cap rates minus government bond yields) have widened in 2020.



Source: *Ares. Real estate risk premium data based on CBRE and RCA data for real estate cap rates, Federal Reserve and ECB data for sovereign bond data.*

To date, there have been fewer bankruptcies than may have been anticipated at the outset, due to lenders showing a willingness to forbear from foreclosing on challenged loans. Where there have been bankruptcies, these have mostly been in the CMBS space where there is less flexibility for temporary restructuring, or "amend and pretend". This is evident in the much higher CMBS delinquency numbers as compared to loans made by banks, life insurance companies and the agencies (Fannie and Freddie). Loan modifications have been significantly higher for life insurance companies than for CMBS. By all measures, the most impacted sectors have been retail and hospitality. Delinquencies in office, multifamily, and industrial have remained low as tenants in those sectors have remained in better economic health and rent collections remain high, generally 90%+.

Exhibit 3

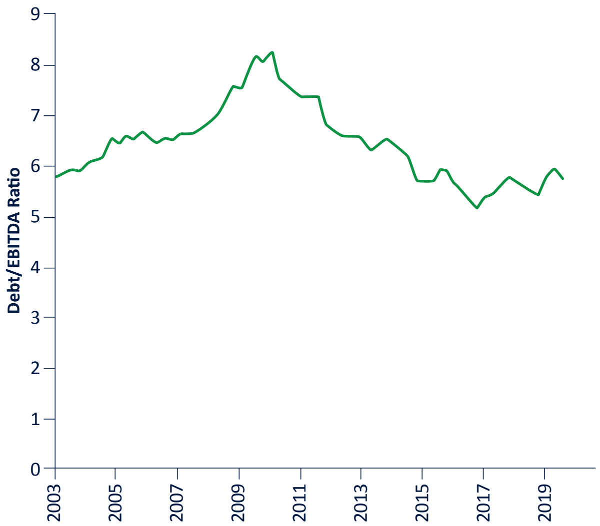
CMBS delinquencies have been highest in the retail and hospitality sector

	CMBS			Bank	Life Insurance	Agency
	Dec-19	Mar-20	June-20	Dec-20	Dec-20	Dec-20
Industrial	1.45%	1.57%	1.14%	0.41%	0.03%	
Multifamily	2.00%	3.29%	2.75%	0.39%	0.10%	0.60%
Office	1.98%	2.66%	2.18%	0.37%	0.06%	
Retail	4.42%	28.07%	12.94%	1.44%	0.24%	
Hotel	1.53%	24.30%	19.80%	3.82%	1.45%	

Source: *Trepp*

Due to the cyclical nature of real estate construction, past downturns have often been preceded by a period of rising leverage and increasing development activity. When the cycle turns, a decrease in tenant demand precipitates a supply-demand imbalance creating headwinds for rents, occupancy rates, and ultimately, valuations. However, given the higher lending standards in real estate following the Global Financial Crisis in 2008/9, leverage levels have remained muted in recent years, and demand has outpaced supply in aggregate for every major sector. As such, most markets began 2020 in a healthier fundamental position than the period preceding the GFC. Vacancy rates in the office sector increased during 2020 but began the year at historic lows in Europe. While vacancy rates have been higher in the US, they began the year well below the 20-year average of c.15%, according to CBRE data.

Exhibit 4
Leverage remained stable in recent years, compared to a meaningful increase prior to the GFC



Source: *S&P Global Market Intelligence, Nareit-Tracker*

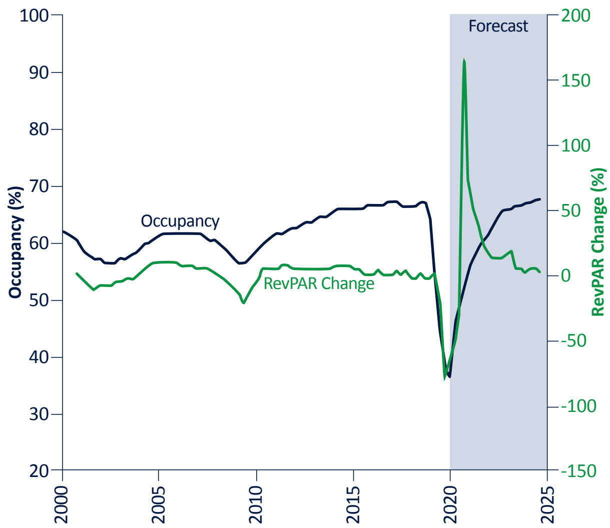
Exhibit 5
Many European citi es entered 2020 with close to record low vacancy rates for office, though vacancies were meaningfully higher in the US

	Q4 2019	Q3 2020
London	5%	5%
Paris	4%	6%
Berlin	2%	3%
New York	9%	12%
Boston	12%	15%
San Francisco	5%	14%
Hong Kong	3%	5%
Shanghai	11%	13%

Source: *JLL, Tishman, CBRE*

However, undoubtedly the pandemic has impacted tenant demand and will continue to do so, to varying degrees, in different sectors. In the short term, hospitality has been the most impacted due to the severe restrictions on travel. In the US, RevPAR (Revenue Per Available Room) declined by more than 40%. Although some analysts predict a sharp recovery when restrictions are lifted, the long-term impact on travel remains unclear. We expect business travel to remain muted for several years, with leisure travel likely to resume sooner.

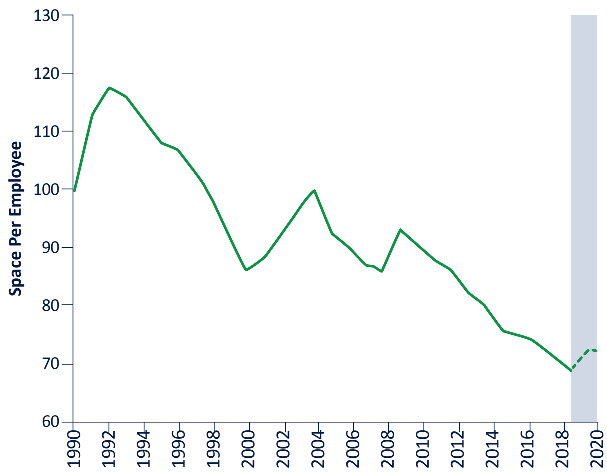
Exhibit 6
Hotel occupancy and RevPAR (Revenue Per Available Room) declined signifi cantly in March and remains depressed



Source: *CBRE*

Future demand in office is highly uncertain due to the offsetting drivers including (1) increased numbers of people working remotely, and (2) reduced density for those employees in the office. Most estimates suggest that this will result in a net decrease in aggregate demand for most regions. Green Street estimate a net decline in demand of c.15% for London, c.10% for the US (average), and c.5% for Europe (average). The impact is expected to be most acute for older, Class B or C properties.

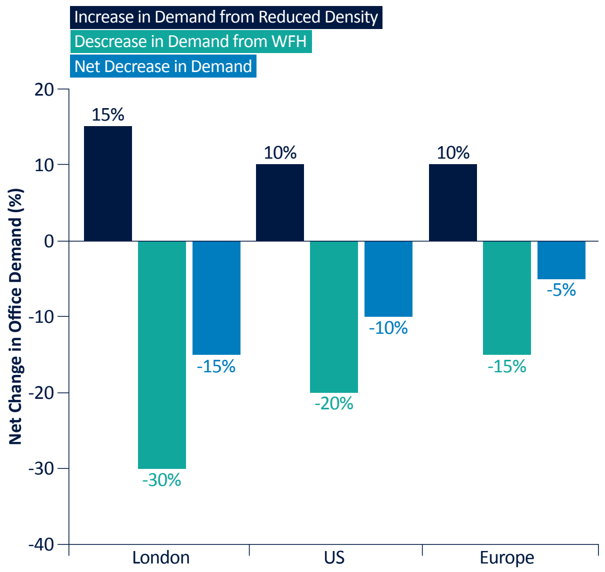
Exhibit 7
Central London office space per employee has shrunk by 30% since 1990. A reversal of this trend may partially off set the increased proportion of employees working from home.



Source: *CBRE*

Exhibit 8

Net aggregate demand for office is expected to fall by -5 to -15% as the impact of working from home outweighs a projected increase in space per employee

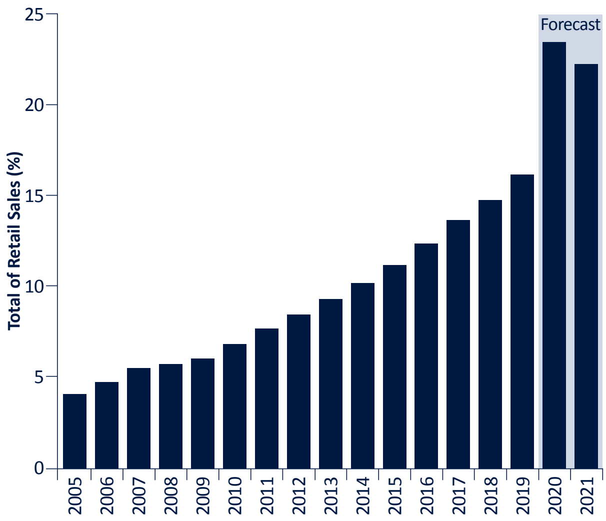


***Source:** Green Street*

The contrasting fortunes for the industrial and retail sectors continued in 2020, as the shift from in-store to online shopping accelerated, negatively impacting demand for physical retail while providing further tailwinds for last-mile distribution demand.

Exhibit 9

E-commerce sales penetration expected to increase from 16% of total US retail sales in 2019 to c.24% in 2020.



***Source:** CBRE*

Aside from industrial, multi family has so far proved to be the most resilient sector in the current pandemic environment. The sector has several defensive characteristics including the large tenant base and the reasonably stable aggregate levels of demand, driven primarily by demographics rather than economic or consumer trends.

Most properties are performing in line with expectation though there have been isolated instances of distress in the sector. Developers with newly completed vacant assets and impending debt maturities have faced the most challenges, and investors with a longer ti me horizon have in certain cases been able to acquire these assets at meaningful discounts to development cost. The other area which has seen challenges are the high-end luxury properties in major cities such as New York and San Francisco. The tenant profile in those properties meant many had the option of leaving the city, resulting in higher vacancy and much larger concessions on the landlords' part in order to attract new tenants.

While occupancy rates in aggregate have been stable at c.95%, the sector has not been immune from challenges. In Q4, media reports referenced numbers from $34B up to $70B of back-pay owed on rents. This would equate to c.6-13% non-payment of the total annual rent in the US, compared to c.5% implied by official NMHC data. We expect the NMHC may not fully capture agreements between landlords and tenants on rent deferrals, and the sample set may be skewed towards higher quality apartments. Examining results for multi family REITs, which are mostly focused on Class A and B, bad debts have been closer to c.2-3%, and of the 97-98% rent categorised as "collected", c.98% of that has been in cash.

The impact of COVID-19 is therefore likely to be felt most acutely in Class C, generally occupied by lower-income renters. Interestingly, Freddie Mac data shows that rents and occupancy were broadly fl at for Class B and C apartments in 2020, but for Class A, occupancy was c.0.7% lower and rents c.-5% lower than 2019. We expect the impact on Class A has been felt soonest due to the greater financial flexibility of tenants in those apartments, who may have chosen to vacate early. By contrast, the seemingly strong occupancy and rent numbers for Class C are likely to be driven by the eviction moratorium, and landlords' inability to remove non-paying tenants. We expect the likeliest scenario in Class C is that these rents are never collected and are ultimately borne as bad debts by the current landlord, which may precipitate a rise in bankruptcies in this space.

In this environment, our focus continues to be on value-add opportunities for Class B. While we expect there to be less distress in this segment due to the more robust fundamentals, we nonetheless expect there to be selective opportunities to acquire assets at discounted valuations from forced sellers, including overleveraged developers facing near term leasing challenges and open-end diversified funds with outstanding redemptions.

Exhibit 10

Multifamily rent and occupancy metrics have been stable in 2020

Property Class	A	B	C
Rent change (12months)	-4.7%	0.6%	1.7%
Occupancy Rate	94.6%	95.7%	96.3%
Occupancy Rate Change (12months)	-0.7%	-0.1%	0.1%
Days Vacant on turn	28	29	32
% of Units offering Concessions	25.7%	22.9%	19.9%
Rent % Concession	6.8%	5.1%	5.4%

Source: *RealPage, Freddie Mac*

2021 Investment Strategy

Core Property

Historically, core property does not lend itself to alpha generation given the fact that assets are typically fully-leased upon acquisition. While investors can generate outperformance picking the right markets and the right sectors, pricing is relatively efficient. When comparing the potential risk-adjusted returns, we do not recommend an allocation to core property through traditional structures.

We have favoured “core-plus” strategies which are generally focused on well-located assets with the potential to be considered “core” but with some current impairment such as underinvestment or moderate vacancy. Managers then aim to undertake minor value-add initiatives to improve and reposition the assets. We have collaborated with our traditionally PERE-focused managers to launch proprietary funds pursuing this strategy.

Core-plus opportunities usually arise from a lack of capital expenditure or oversight from owners of core assets. This creates opportunities for skilled managers to acquire assets at a discount, address the outstanding physical or operational issues at the properties, and benefit from an above-average yield on cost. We believe we can achieve outperformance of 150-200 bps net of fees[4] over the long-term through this strategy, on an unlevered basis. The return can be enhanced with a prudent amount of leverage, usually between 30-50% LTV, to achieve net returns of 7-9%, vs. c.5% for core property.

Private Equity Real Estate

We believe there is an attractive alpha-generating opportunity in private equity real estate, particularly with managers who are vertically integrated owner-operators, i.e. with in-house investment, asset management and development expertise. We believe there are several factors that can drive outperformance: i) uncompetitive investment opportunities, ii) sector and asset selection, iii) favourable financing, iv) complex business plan execution. The managers we invest with bring at least one of these factors to bear.

In 2021, we continue to focus on managers with deep local expertise, who can generate proprietary deal flow, and who have demonstrated an ability to add value through asset repositioning. We find this asset-focused approach is most reliable and can generate strong returns in any market environment.

We expect to deploy capital with sector specialist managers in both last-mile logistics and Class B multifamily. These are sectors which we believe will be resilient in the post-COVID environment. We are also closely monitoring the distressed opportunity set.

In last-mile logistics, we believe there is a strong value-add opportunity for managers with the skill to convert traditional industrial assets and convert them to modern distribution facilities. Taking Boston as a case study, we estimate that rents are on average c.15-20% higher for last mile logistics assets while there is a meaningful cap rate premium of between 1-2% for exiting these facilities to “core” buyers. With moderate leverage, this dynamic creates a clear path to generating target returns of 15-20% gross IRR.

Likewise, in multifamily we believe that skilled managers can generate attractive returns by applying a consistent operational “playbook” for increasing rents and reducing expenses. On the revenue side, experienced managers can acquire underinvested buildings and drive rent growth

[4] Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance. Please see important Disclaimers at the end of this material.

by refurbishing individual units and common areas to create higher quality assets commanding higher rents. On the expense side, managers with large portfolios can drive meaningful incremental savings on items such as insurance, property management and maintenance through economies of scale and clustering of nearby assets. We believe there will be opportunities to acquire well-located Class B assets from forced sellers, including overleveraged developers facing near term leasing challenges and open-end diversified funds with outstanding redemptions. We will avoid the luxury and workforce housing segments of the market, where we believe fundamentals are less compelling.

We have been actively monitoring and reviewing distressed opportunities. To date, most distressed transactions have been in the retail and hotel sectors, and to a lesser extent office. In all three sectors, forecasting future tenant demand presents significant challenges. As such, we are focused on opportunities in high-quality well-located assets where managers can create a margin of safety by acquiring at a significant discount to pre-COVID pricing. We expect these opportunities to arise primarily from broken capital structures, usually overleverage on the previous owner's part. In the near term, these opportunities are mostly likely to arise from CMBS borrowers, who have less flexibility to modify their loans. In the medium term, we expect that banks and other traditional lenders currently adopting an "amend and pretend" will begin sales of non-performing loans, due to the costly nature of maintaining these on their balance sheet. As such, on the distressed side we will seek to partner with managers who have strong sourcing relationships across CMBS special servicers, banks and other lenders. In addition to loan workout and foreclosure capabilities, which are a pre-requisite for distressed investing, we are focused on managers with the deep in-house real estate expertise required to turn around challenged assets.

Exhibit 11

Core Property Total Return Expectations by Scenario

Scenario	Summary Analysis	2021 Calendar Year Total Expected Return	Weighted Return	Long-term Return Forecast	Recommended Deviation from Benchmark for 2021
Upside Scenario: "Warp speed to normal growth" (20% probability)	Cap gains of 2 - 2.5% and rental income or 3.5%. Manager alpha adds an additional 100 bps to performance.	**7%**			
Base Case: "The herd slowly immunises" (60% probability)	Cap gains of 1.0 - 1.5% and rental income or 3.5%. Manager alpha adds an additional 100 bps to performance.	**6%**	**4.4%**	**6.3%**	**0.0%**
Downside Scenario: "Ongoing waves" (20% probability)	Cap gains of -4.0% as prices fall on back of growth shock and delinquencies, which also causes rental income to drop to 2.0%. Manager alpha adds an additional 100 bps to performance.	**-1%**			
TAA Implications of short-term returns vs. long-term expectations	Real estate is inherently sensitive to interest rates, which we expect to increase over the near-to-medium-term. However, the longer-term outlook for property remains robust, with favourable supply/demand dynamics, a steady income stream and some embedded inflation protection. We are neutral on core, preferring PERE where there is better scope to add alpha via the repositioning of assets.				

Notes: ***Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.***

Exhibit 12

Private Equity Real Estate Total Return Expectations by Scenario

Scenario	Summary Analysis	2021 Calendar Year Total Expected Return	Weighted Return	Long-term Return Forecast	Recommended Deviation from Benchmark for 2021
Upside Scenario: "Warp speed to normal growth" (20% probability)	Core property markets gains +6.5% and PERE managers capture 2x this return due to operating performance improvements and leverage.	**13%**			
Base Case: "The herd slowly immunises" (60% probability)	Core property markets gains +5.5% and PERE managers capture 2x this return due to operating performance improvements and leverage.	**11%**	**8.8%**	**10.3%**	**0.0%**
Downside Scenario: "Ongoing waves" (20% probability)	Core property index declines -1.0% and PERE managers capture 2x this return due to higher leverage.	**-2%**			
TAA Implications of short-term returns vs. long-term expectations	Both the near-term and longer-term outlook for PERE remains robust, with low borrowing costs, favourable supply/demand dynamics, a steady income stream, some embedded inflation protection and the opportunity to reposition assets to generate incremental returns. Short-term return forecasts are modesty lower than our long-term outlook, reflecting potential near-term headwinds from COVID-19. Given this is an illiquid asset class, there are no practical TAA implications.				

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