Asset Class Investment Strategies

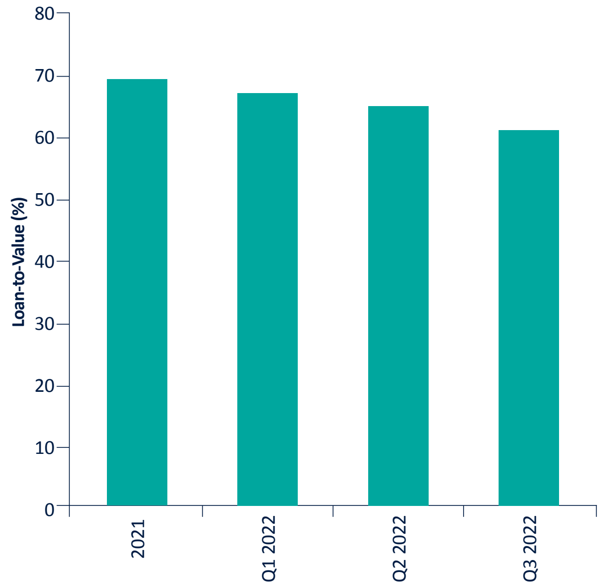
Real Estate

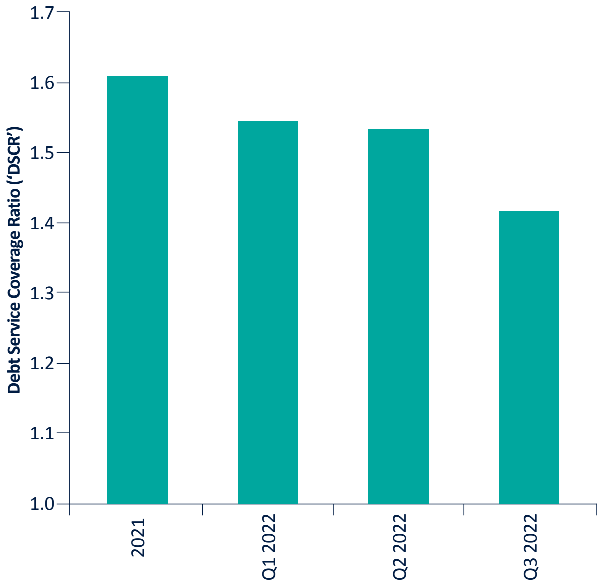
Major Trends

Increased financing cost and reduced leverage levels available in lending markets: In 12 months, the cost of debt has increased c.+4.0-5.0%, comprised of a base rate increase of c.+4.25%[1] and a c.+0.5-1.0%[2] increase in spreads. By way of example, the cost of debt for a typical acquisition in multifamily has increased from c.1.5% (SOFR + 145bps, when SOFR was 5bps) to c.6.3% (SOFR + 195bps, with SOFR at c.430bps). In addition, the availability of financing has decreased as traditional lenders, in particular money-center banks, curtail lending. Banks are effectively out of the office and retail markets for the near term at the direction of regulators who are seeking to reduce banks' exposure to challenged sectors. For borrowers that can access financing, the amount of debt they can obtain, as a loan-to-value ratio (LTV), has declined. Lenders are seeking to maintain or increase debt service coverage ratios and, due to the higher cost of debt, the total debt balance a property can maintain has fallen. The average multifamily loan in the Freddie Mac program had a 61% LTV in Q3 2022, compared to 69% in 2021.[3] Borrowers with impending debt maturities may not be able to refinance the entire principal, and as a result, may need to invest additional equity to cover repayments. This is particularly true for sectors which have seen flat or negative net income growth in recent years, such as office or retail. Trepp[4] estimates there are 160 office and retail CMBS loans maturing in 2023, totaling $3.75B, which have debt service coverage below 1.0x. We believe these dynamics are creating an attractive opportunity for investors that can provide flexible capital solutions including whole loans, bridge financing or preferred equity, as long as those investors have the willingness and expertise to take control of the property if needed. In prior periods of market stress, the opportunity set has become actionable in the US earlier than in Europe, as lenders in Europe have typically been slower to resolve challenged loans.

Exhibit 1

Lenders have reduced the LTV they are willing to provide: the average multifamily loan in the Freddie Mac program had a 61% LTV in Q3 2022, compared to 69% in 2021[3]





Source: *Freddie Mac*

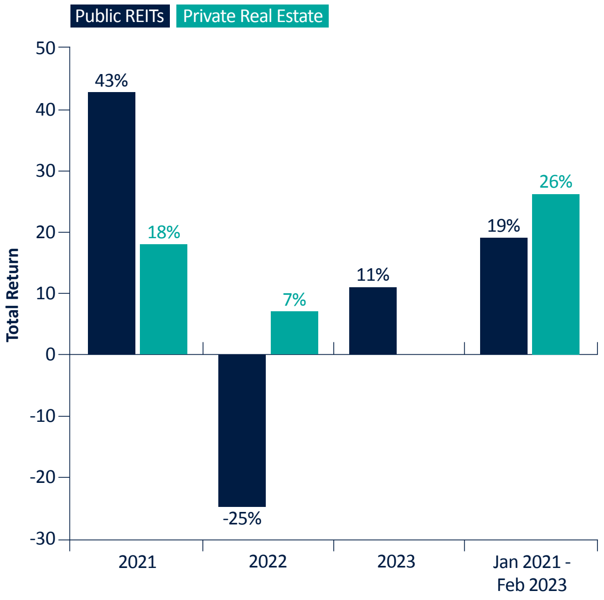
1. SOFR Curve, St Louis Fed
2. Trepp CMBS Data
3. Freddie Mac K-Series January 2023 Performance Report
4. Trepp CMBS Data

Converging valuations in public and private markets: We believe there will be a c.-5% decline in reported valuations for private real estate in the first half of 2023,[5] bringing about a convergence in public and private real estate values. This is in line with an analysis by Green Street, which estimates that public REITs trade at a discount to NAV of 3%, as of February 2023.[6] Based on the acquisition activity of our partners, we believe true real time private market valuations have adjusted lower than the data implies due to the lagged recording of private transactions. For Public REITs, while we believe they are currently modestly undervalued, we do not believe current valuations represent a clear buying opportunity. US public REITs declined -25%[7] in 2022 compared to a +7% return for private real estate.[8] In the first five weeks of 2023, REITs have recovered +11%, taking the performance since beginning of 2022 to -17% compared to +7% for private real estate. However, it is necessary to consider the starting point, as much of the decline for REITs in 2022 was simply a reversal of extraordinary performance in 2021. In 2021, private real estate returned +18%,[3] while public REITs gained +43%,[4] meaning REITs began 2022 at record low implied cap rates. By way of example, Prologis began the year at an implied cap rate of 2.7%.[9] It finished the year at an implied cap rate of 4.2%, suggesting a return to more normal valuations today rather than a significant discount.

Industrial, multifamily and hospitality have robust but moderating fundamentals: Industrial and multifamily continued to generate strong revenue growth, as sub-5%[5] vacancy in these sectors has enabled owners to increase rents at or above inflation. Despite Amazon slowing the growth of its logistics footprint, many ecommerce retailers and third-party logistics firms remain in catch-up mode. The US industrial sector continued to experience strong fundamentals in 2023, with 400M square feet of leasing, 60% above average leasing volume from 2017-2019.[10] This led to rent growth of 21%[10] in 2022, taking cumulative 3-year rent growth to 48%.[9] In multifamily, demand has been supported by the sharp rise in the cost of ownership relative to the cost of renting. Rent growth in 2022 was 13%,[10] taking 3-year rent growth to 17%.[9] This is anticipated

Exhibit 2

Viewing 2022 returns in isolation overstates the implied valuation gap between public and private real estate



***Source:** MSCI US REIT Index (for Public REITs), ODCE Index (for Private Real Estate)*

to slow to 3-4%[9] per annum over the next 5 years. Hospitality experienced a strong recovery in 2022 and is now recording revenues in line with pre-COVID levels, albeit with certain segments, such as drive-to leisure, leading the recovery and others, such as business hotels, continuing to lag.[10]

5. Hypothetical return expectations are based on simulations with forward looking assumptions, which have certain inherent limitations. Such forecasts are not a reliable indicator of future performance
6. Green Street data
7. MSCI US REIT, Bloomberg.
8. ODCE Index as of December 2022
9. Green Street Data
10. CBRE

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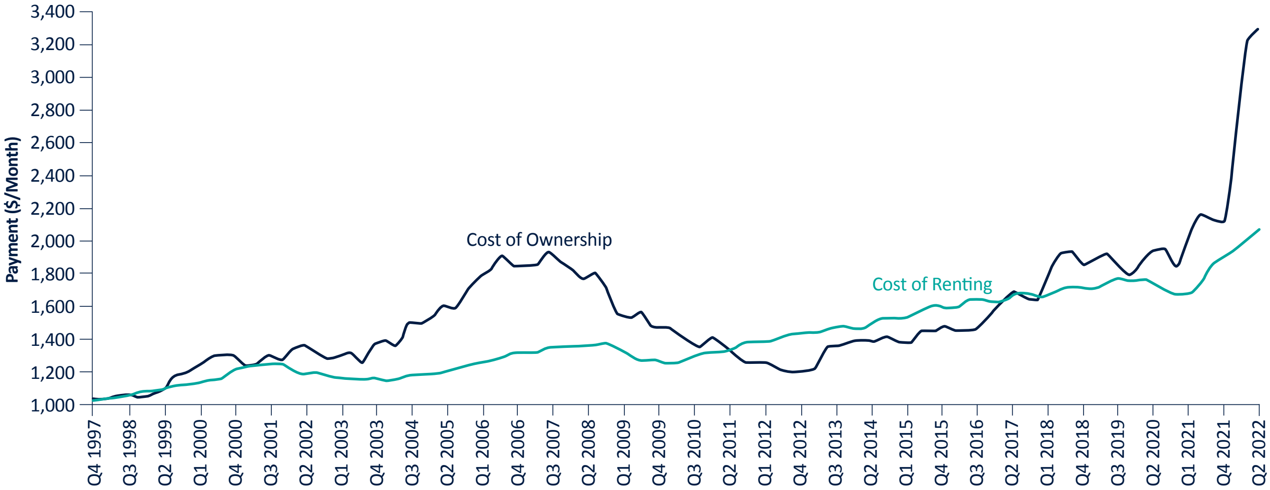
Exhibit 3

The cost of ownership relative to the cost of renting has spiked due to mortgage costs, supporting demand for multifamily



Source: *CBRE Research, CBRE Econometric Advisors, Freddie Mac, Census Bureau, National Association of Realtors, Q3 2022.*

Office faces headwinds: Office was the only exception among major sectors to the positive rent growth in 2022, experiencing a decline of -4%.[9] This figure masks the broader uncertainty facing the sector due to structural oversupply. Many major cities are experiencing close-to-record availability rates. While the same headwinds are facing major office markets in the US and Europe, European markets saw more limited new construction in the years prior to 2020. As a result, the supply overhang is less significant: vacancy rates in major US office markets average 15% vs. 7% in Europe.[13] Tenant demand has been concentrated in newer, higher amenity properties. Properties built since 2015 have seen positive net leasing of 88 million square feet between 2020-22.[14] Older properties have seen negative net leasing of 256M square feet.[14] Landlords are faced with the decision of investing significant capital expenditure to target top tenants or to compete by lowering rents and recognising a meaningful decline in valuation. While there may be some opportunities to convert office to other uses, such as residential or hospitality, investors must be highly selective. A recent Moody's analysis indicated only 3% of office stock in New York was economical to convert to residential.

Increased importance of environmental considerations: Several factors have led to a greater focus on environmental considerations in real estate. Most of the largest corporate tenants have publicly committed to reducing emissions, and managing their real estate footprint is a relatively straightforward means by which to achieve this. Average occupancy in buildings rated "Platinum" from an energy perspective have c.99% occupancy, vs. c.88% for those rated "Silver" and below.[15] Similarly, many large owners of real estate, including public pension funds, are working to achieve similar improvements in "green standards" in their portfolios. Lastly, many regulators have set emissions standards; for example, in London it is already illegal to rent buildings rated "F" or "G", and from 2030, it will be illegal to rent buildings rated "C", "D", or "E". Taken together, these factors mean investors must take environmental considerations seriously when evaluating new opportunities or face value impairment in the future.

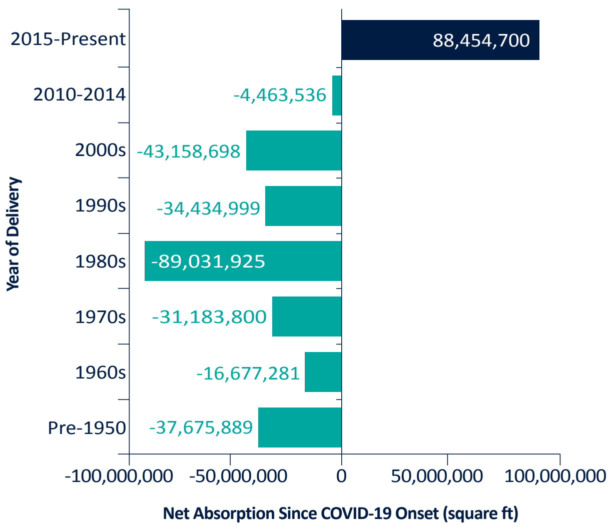
14 Source: AECOM, JLL, CBRE Economic Advisors (2020-2022).
15 Source: CBRE and Goldman Sachs.

Golden Rules

- We aim to build real estate portfolios at stabilised unlevered yields 1-2% above prevailing market cap rates. This can be achieved through acquisition discounts and/or identified net income growth during the hold period. This creates upside in normal market environments and provides a margin of safety against declining market valuations and rising debt costs.
- Partner with vertically integrated managers with excellent operational capabilities and local knowledge.
- Focus on "Buy, Fix, Sell" approach within PERE. For core-plus, "Buy, Fix, Hold" approach in high-conviction markets.
- Be prudent in level and structure of leverage.
- Maintain diversification but skew towards markets with the strongest fundamentals.
- Focus on sectors and regions where institutional demand creates liquid property markets; be wary of tertiary and emerging markets.
- Consider tax benefits or disadvantages, depending on investor type and market.[16]

Exhibit 4

Office demand has been concentrated in newly built Class A buildings



Source: *CoStar, JLL Research, AECOM Capital, CBRE Econometric Advisors*

Sub-Strategy Attractiveness

Industrial: Positive view, in particular for small urban "last-mile" logistics properties. Rent growth is moderating and combined with higher debt costs, market cap rates have increased over the past 6-9 months.[13] Our managers in this space have consistently acquired properties at cap rates 100-200bps wider than market, and this spread is being maintained in today's higher cap rate environment. This has been achieved by acquiring small assets from non-institutional owners, while maintaining a focus on major urban areas. In addition to the traditional portfolio aggregation strategy, we believe there will be an opportunity for investors with expertise in loan workouts to acquire high-quality assets at a discount from overleveraged borrowers. The sharp rise in interest rates will create debt service coverage issues for owners who utilised high leverage and paid peak pricing in 2021.

Multifamily: Positive view, in particular for sector specialists executing buy-fix-sell strategy through a repeatable value-add playbook. We focus on markets with strong fundamentals and limited new supply in recent years. As with industrial, there may be idiosyncratic opportunities to access properties at a discount through loan workouts, and we have seen some early evidence of this through individual loan sales from CLO and CMBS pools.

16 Partners Capital are not tax advisors. 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.

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Non-Traditional: Neutral view. Self-storage aggregation plays with experienced GPs remain solid, due to market fragmentation. Data centres and life science become difficult to access without development activity and face supply gluts in key markets.

Hospitality: Neutral view. Hospitality has the highest sensitivity to economic growth of the major real estate sectors, and a sharp rise in borrowing costs and potential near-term economic headwinds may result in distress even for high-quality assets. The long-term fundamentals for hospitality in many markets are attractive due to limited new supply, and near-term challenges may create attractive entry points.

Office: Negative view. Tenant demand focused on Class A, energy efficient properties. Avoid traditional "commodity" office space. May be select opportunities to upgrade assets in growth markets.

Retail: Negative view. Challenging sector with declining tenant demand and oversupply. Rents remain higher than alternative use value in many major markets, suggesting floor not yet reached.

2023 Strategic Priorities

- Remain focused on allocating capital to industrial and multifamily, sectors in which we have highest conviction in operating fundamentals. Our existing partnerships are focused on acquiring underdeveloped and undermanaged small cap properties, usually on an off-market basis, and driving returns through physical and operational improvements. We believe this strategy will continue to generate strong risk-adjusted returns in these sectors.
- Capitalise on selective opportunities to acquire assets from over-leveraged owners who become forced sellers over the next 12-24 months. We expect to partner with managers with both capital markets expertise, including in credit and foreclosure proceedings, and property management capabilities.
- Target assets we expect to better hedge inflation and defend against cyclical demand pressures. We focus on real estate types with shorter lease lengths and more variable lease structures (including expense pass-throughs to tenants) to manage inflation risk. We also prioritise multifamily and other real estate sectors with less cyclical demand.
- Deploy capital into new property acquisition vs buying existing portfolios at prevailing valuations over at least the next 6 months. In recent years, it was possible to invest in core-plus real estate through open-end funds at attractive valuations, as measured by higher stabilised cap rates relative to public REITs and direct private real estate. The lagged approach to valuation adjustment in core-property funds in the face of sharp price declines in public REITs and lower private transaction prices has eliminated that gap. We instead see a favourable environment to acquire assets at below stabilised market value.
- Increase co-investment activity and introduce structures to improve client access to these opportunities. Due to a slowdown in fundraising environment, we expect there to be more opportunity for low or no fee co-investment, as well as more opportunities to secure fee discounts for scale. More than 85% of the capital committed by our clients in past 12 months was on a reduced fee basis. Certain co-investment and niche investment opportunities are fast moving and require certainty of capital to secure capacity. We are evaluating structures to provide our clients access to these opportunities in a diversified and cost-efficient way.

We divide real estate equity into three categories based on risk-return profile: core real estate, 'core-plus' and opportunistic.

We define core real estate as unlevered investment in stabilised properties, i.e., fully occupied, in major markets. We expect forward-looking net IRRs in core property space to be c.5.5%.[5] This comprises (i) c.5.5% current income, as measured by current aggregate US cap rates, (ii) plus 2.5% for annual net income growth, (iii) less 1.0% for ongoing capital expenses, (iv) less 1.0% management fees and (v) less 0.5% for frictional expenses amortised over a 7-year hold period. Note these return assumptions are based on acquisitions adjusted for what we believe to be today's true valuations, in line with where our managers are currently acquiring assets, rather than currently reported private valuations.

We define core-plus strategies as those acquiring assets which have the potential to be considered core but with 1-2 current impairments, e.g., low occupancy or in need of minor refurbishment. In addition, core-plus strategies typically utilise modest leverage of 40-50% LTV.[17] We expect net IRRs in core-plus to be 9-10% going forward.[5] Here, we are using the same inputs as core property, but with additional assumptions including (i) 45% LTV, (ii) 5% cost of debt, (iii) additional 2-3% annual net income growth through property improvements, (iv) capital expenditure equal to 10% of purchase price to address impairments and catalyse rent growth and (v) a 10% performance fee, as is standard for these funds.

We define opportunistic strategies as those that take significant business plan risk, from major refurbishment and lease-up strategies through ground-up development. We expect net IRRs in opportunistic real estate to be 11%+ going forward5. These returns are based core-plus assumptions adjusted for (i) higher leverage (65% LTV), (ii) higher cost of debt (6%), (iii) higher capital expenditure requirements (20% of purchase price), (iv) higher annual net income growth (6%) which includes increase in occupancy and headline rent rates and (v) higher management fees (1.5%) and performance fees (20%). As can be inferred from the return build-up, opportunistic strategies are higher risk than core and core-plus, due to the higher leverage, the larger investment required post-acquisition and the wider the gap between starting and ending net income. As such, results in opportunistic strategies are more reliant on a manager's skill and execution capability. For this reason, we believe the alpha potential is greatest in opportunistic.

17 Industry average calculated using core-plus property funds for Blackstone, Ares, Tristan, Brookfield, and KKR.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Real Estate

	Real Estate
Risk-free Rate	3.5%
Risk Premium	3.0%
Illiquidity Premium	3.0%
Manager Alpha	1.0%
Total Return	**10.5%**

Beta return of 6.5% for core property forecasted as +5.5% starting NOI, plus +2.0% net cash flow growth, minus -0.5% maintenance capex, minus -1.5% standard industry fees and expenses. Premium for opportunistic real estate of 3.0% p.a. reflects illiquidity premium, property enhancement skill set and higher leverage of specialist private equity firms, plus 1.0% for our strategy and manager selection.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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