Real Estate

Major Trends

Past performance is not indicative of future returns, your capital is at risk and you may not get back the full amount invested.

A tighter financing market is creating challenges for real estate investors, but creating opportunities for non-traditional real estate lenders. In 2023, an already tight financing market for real estate investors became more challenging. Interest rate hikes beginning in 2022 created uncertainty around property values, and credit conditions began to tighten. This trend accelerated in Q1 2023 following the failure of Silicon Valley Bank and Signature Bank, which had knock-on effects on the broader regional bank sector. Concerns around real estate caused those banks to meaningfully reduce lending activity. Bank lending to real estate declined 67% year-over-year[1]. Many banks also reduced their exposure through the sale of loan portfolios, often at a discount to face value of 5% or more[2]. The pullback of traditional lenders creates an opportunity for private lenders to generate attractive risk-adjusted returns. Our partners in this space are originating senior loans at 10%+ yields[2], against strong underlying collateral with modest loan-to-value levels (55-70%[2] based on revised valuations reflecting today's environment).

Valuations have continued to decline in 2023. There continues to be a disconnect between public and private valuations, though this is narrowing. In 2023, Green Street Advisors estimated property values declined -10% in the US and -11% in Europe[3]. Office valuations were the most impacted, declining -27%[3], while industrial was the least impacted of the major sectors, declining -2%[3]. Net income remained stable or continued growing for most sectors; however, the higher risk-free rate and increased cost of borrowing have pushed cap rates higher, which reduces valuations.

The gap between public and private valuations has been much discussed in recent years, and thus far, this dynamic has played out in line with prior dislocations. Between January 2020 and December 2023, REITs returned +8% while private real estate returned +12% (Exhibit 1). However, this masks considerable variance on a year-by-year basis. REITs have exhibited significantly more volatility: arguably overshooting, then overcorrecting, then recovering to their current levels. Meanwhile private real estate valuations have been slow to adjust to the new market environment and are only now achieving valuations approximately in line with public real estate.

Over the period, implied cap rates for public REITs have risen from 4.5% in 2021 to 5.7% in 2023[4], while valuations for private real estate have risen from 4.7% to 5.5%[4], or a valuation 'gap' of c.4%. There are exceptions. Office assets trade in the public markets at implied cap rates of c.8-9%[4], while private market cap rates remain 6-7%[4], implying there may be further adjustment to come in that sector. Conversely, in the Industrial sector, values appear equivalent (4-5% in-place cap rates[4]), while in data centres, public REITs valuations are higher than private markets (4.5% vs. 5.5%[4]).

While the aggregate valuation gap of c.4% implies real estate remains 'cheaper' in the public markets, these reported private valuations do not reflect the new acquisitions we are seeing our managers execute. In 2023, all new acquisitions we have seen from our managers have stabilised cap rates above 6%, and often above 7%. We do not think that

1. Mortgage Bankers Association Q3 2023 Commercial / Multifamily Quarterly Databook.
2. Market-level data on loan sales is unavailable given many of these transactions are not reported. We have observed over $2B of real estate loans trading privately at discounts of 5-10%, and several publicly reported transactions have transacted at similar or higher discounts.
3. Green Street Commercial Property Price Index.
4. CenterSquare REIT Cap Rate Perspective Q4 2023. Note: REIT cap rates are approximated based on reported cap rates in November 2023, rolled forward based on REIT performance December 2023 (+9.6%). Private real estate cap rates are based on NCREIF ODCE data.

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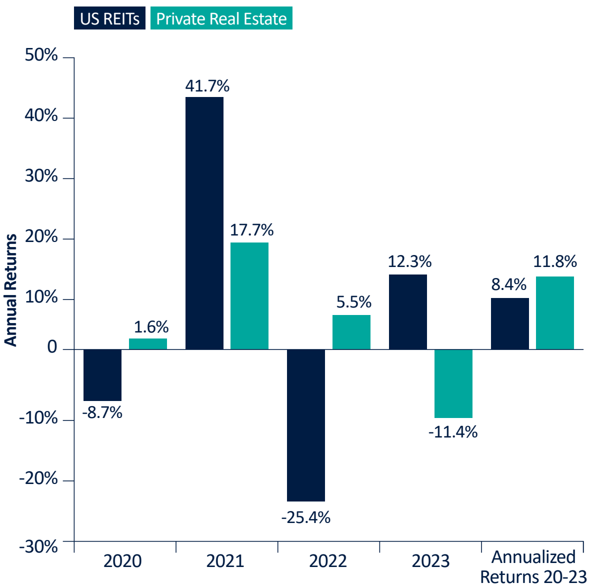
is necessarily a harbinger of future market-level valuations, but rather a reflection that our managers were able to acquire assets at cap rates 100 basis points wide of market or more.

Despite significant year-over-year variance in public and private market returns in recent years, aggregate returns over the period have been broadly comparable.

Exhibit 1

Public and private real estate returns have differed sharply year-over-year, but look similar over the past 4 years in aggregate



Source: *US REIT data is MSCI US REIT Index. Private Real Estate data is NCREIF ODCE Index*

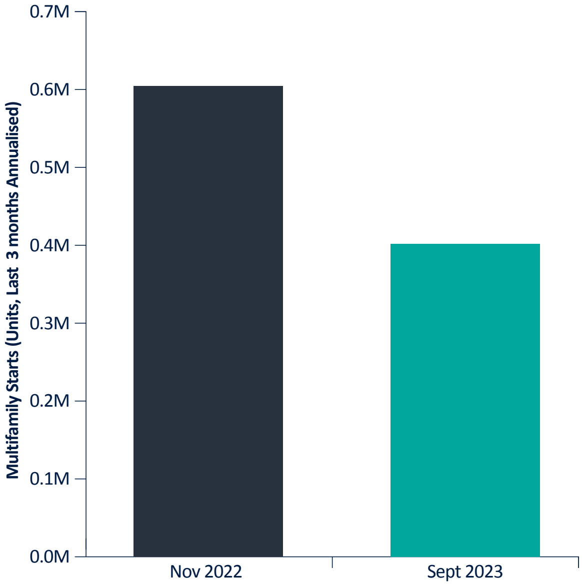
Transaction volumes declined 56% compared to 2022 against a backdrop of declining credit availability and uncertain valuations. Notably, this decline is broadly consistent across all sectors and geographies. In this new environment with higher cost of debt, buyers require meaningful discounts relative to peak valuations to achieve their return targets. Meanwhile, property owners, particularly those with fixed rate debt, are electing to hold rather than sell into a difficult market. Although this has meant the actionable opportunity set in 2023 was limited, our managers made attractive acquisitions, often with stabilised cap rates of 7% or higher. We expect transaction volumes to increase in 2024 while remaining below the peak volume of 2021, as debt maturities and balance sheet pressure will bring sellers to market.

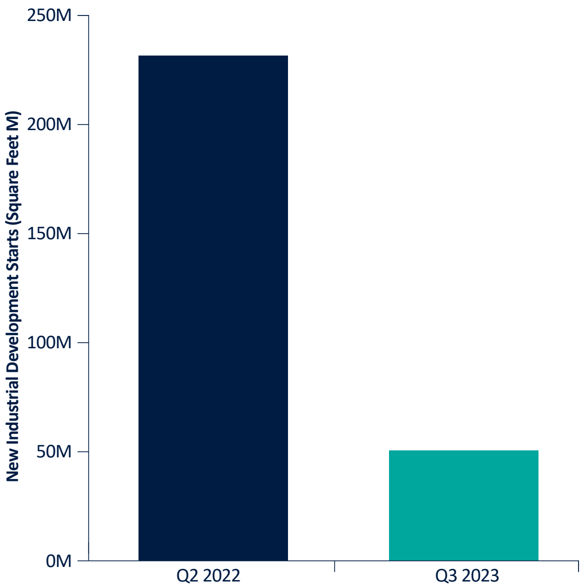
New development starts are declining by 30-80%[5], consistent with prior periods of market dislocation. This is driven in part by declining values for existing assets. While upward pressure on certain development costs – including labour and materials costs – has subsided, overall development cost has not fallen to the same extent as values for existing assets. With pockets of stress emerging, in some cases it is possible to acquire assets at valuations below replacement cost, making development less attractive. Other factors are also at play including uncertainty around the leasing market environment over the medium term and the challenging financing markets. Estimates vary, though it is expected that new development starts in industrial have declined between 50-80% from its peak in 2022, while new starts in multifamily have declined by c.33%[5,6](Exhibit 2). Completions will remain at trend in 2024, which may result in modest increases in market-level vacancy rates, and the decline in new starts will begin constraining supply beyond 2025.

5. JLL Q4 2023 Industrial Market Beat Report.
6. Bridge Investment Group. Data based on RealPage, as of Q2 2023, Moody's Analytics, Baseline Scenario, as of July 2023.

Exhibit 2

Multifamily starts and Industrial Development have declined c. 33% and c. 80% from peak, respectively





Source: *Data sourced from CenterSquare 2024 Global Market Outlook. CoStar data shows industrial starts declining by 78% between Q2 2022 and Q3 2023. US Census Bureau data shows multifamily starts declining by 33% between November 2022 and September 2023*

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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 Private Equity Real Estate. For core-plus, pursue a “Buy, Fix, Hold” approach in high-conviction markets.
- Focus on sectors and regions with the strongest fundamentals, where institutional demand creates liquid property markets; be wary of tertiary and emerging markets.
- Be prudent in level and structure of leverage.
- Consider tax benefits or disadvantages, depending on investor type and market.

Sub-Strategy Attractiveness

- **Private Equity Real Estate (‘PERE’) vs. Core and Core-Plus Real Estate:** Focus on PERE in 2024. Asset owners traditionally have two options for investing in real estate: (1) closed-end funds in which the GP draws down capital to make new acquisitions (typically these are Private Equity Real Estate or ‘PERE’ funds) and (2) open-end funds in which LPs buy into an existing portfolio (typically core or core-plus strategies). While we believe core-plus funds serve an important role in our strategic asset allocation, for new investments in real estate in 2024, we believe making new acquisitions is more favourable than entering

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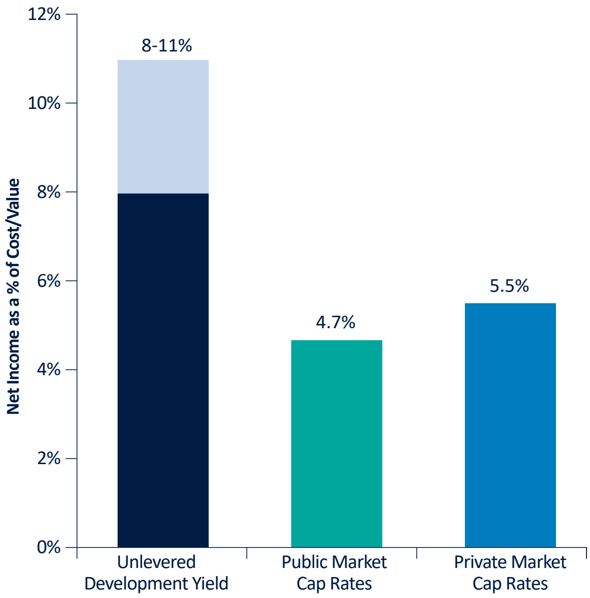
an existing portfolio at appraised valuations. As described in the Market Trends section, although appraised values for private real estate are beginning to catch up with public real estate valuations, our PERE managers have been acquiring assets at compelling valuations, often at cap rates 100-200 basis points wider than market. We also prefer the greater value-add potential in acquisitions by PERE funds, especially given the current uncertainty in financing and valuation environment. Due to this dynamic, we are focused on deploying capital through PERE funds rather than Core or Core-Plus funds over the next twelve months.

- **Industrial:** Favourable view. Vacancies remain at or below 5% in most major markets[7]. Growing e-commerce penetration and a trend towards 'near-shoring' supply chains continue to drive demand. We favour accessing the space through owner-operators executing a portfolio roll-up strategy in small (100-250K square feet) last-mile assets. Small assets continue to trade at a discount to large portfolio sales, and there is an opportunity for those operators to create additional value by re-positioning and re-leasing older properties. While the sector is not immune to the challenging capital markets environment, there is evidence of continued demand for portfolio acquisitions, most notably Prologis' acquisition of a $3B portfolio from Blackstone at a cap rate of 4% in July 2023.
- **Digital Infrastructure:** Favourable view. The rapid growth in data consumption driven by internet usage and cloud adoption is set to further accelerate as AI adoption becomes more widespread. While demand drivers are well understood, supply remains constrained due to challenges accessing appropriate sites with ability to secure the right zoning and access to sufficient power. We believe there is an opportunity to partner with experienced managers in this space, with the network and execution capabilities to take advantage of long-term secular growth, driven by demand for compute and storage. We are seeing opportunity to develop assets at unlevered yields on cost of 8-11%[8], which compares to private market cap rates of c.5.5% and public market cap rates of c.4.7%[8] (Exhibit 3).

Exhibit 3
Strong demand and finite supply in data centers is creating the opportunity to generate attractive yields for experienced developers



Source: *Unlevered development yields for data centers based on data from three major data center developers. Public and private cap rates sourced from CenterSquare REIT Cap Rate Perspective Q4 2023*

7. Avison Young Q3 Office Report.
8. Whitman Peterson Report Q1 2024. CBRE Econometrics Advisors estimate a 55% decline in industrial starts relative to 2022 peak. In its Q4 2023 earnings call, Prologis estimated new starts declined by two-thirds.

Multifamily: Neutral view. In 2023, multifamily experienced moderating rent growth (+0.7% year-over-year) and modestly rising vacancy (from 4% to 5%)[1]. Supply is expected to increase as developments initiated in 2021 and 2022 are completed and come to market. We expect 2024 will be much like 2023, with low or possibly negative rent growth and modestly increasing vacancy. Nonetheless, we remain positive on the space given the robust medium- and long-term fundamentals. While the cost of renting rose 21% since 2019, the cost of owning has risen 93%, increasing the pool of renters[9]. Additionally, values have rebased, such that buyers can acquire assets today at cap rates of 6% or more, above the cost of fixed rate agency debt, with a path to further growth through value-add initiatives.

Hospitality: Negative view. We expect a slowdown in consumer spending will create headwinds for hospitality. Alongside office, hospitality is the sector most exposed to further economic weakness given the profile of short-dated income and operational leverage. Additionally, many managers deploying capital in the space will face challenges in their existing hotel portfolio, taking time and attention away from new transactions.

Office: Negative view, particularly in the US where vacancy rates are reaching record levels close to 20%. While valuations have declined meaningfully, we believe the uncertainty around true valuation remains unclear. As described in our 'Golden Rules', we seek to build real estate portfolios at stabilised unlevered yields 1-2% above unlevered cap rates. Leasing volume in office has been c.30% lower than historic average in each of the past four years[10]. Much of that leasing activity has been concentrated in trophy properties, and most has come with higher-than-usual rent-free periods and tenant incentives. As such, achievable market rents remain highly uncertain, making it challenging to assess true valuation and build conviction in the sector.

9. CenterSquare 2024 Global Market Outlook. CoStar data shows industrial starts declining by 78% between Q2 2022 and Q3 2023. US Census Bureau data shows multifamily starts declining by 33% between November 2022 and September 2023.
10. Unlevered development yields for data centers based on data from three major data center developers. Public and private cap rates sourced from CenterSquare REIT Cap Rate Perspective Q4 2023.

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2024 Strategic Priorities

- **Continue to pursue targeted investment strategy in real estate.** We believe that the opportunity for generating attractive returns in real estate is under-recognised and that a strategy focused on vertically-integrated PERE funds specialising in attractive sectors best exploits the opportunity. Our key views on the investment opportunity and strategy, which we will share in more detail with clients in the future, are as follows: Manager selection and sector selection play critical roles and have a meaningful impact on investor returns. With respect to manager selection, we believe 'owner-operators' have several structural advantages over 'allocators', and these advantages have been borne out in relative performance historically. With respect to sector selection, we believe sub-sectors in real estate can experience tailwinds or headwinds that endure for several years, and that investors should skew towards sectors with durable supply/demand imbalances.
- **Invest in digital infrastructure opportunities.** As described in the section above, we believe there is a compelling opportunity set in the space today. We have spent several months mapping this space and meeting with managers to draw up a short list of potential partners. We expect to identify at least one high conviction opportunity in this space in 2024.
- **Continue to drive fee discounts and other favourable economics.** Fundraising in real estate declined c.50% in 2023, with many LPs taking a broad-brush approach to reducing their exposure. Despite headwinds, we believe there are attractive opportunities to deploy capital, and with a relative scarcity of LP capital, we are in a strong position to drive fee discounts and other favourable economics. For investments made in 2023, we secured a weighted average management fee discount of 0.4%.

Long-Term Expected Return

Exhibit 4
Based on our 10 year forecasts, we target the following long-term expected returns for Real Estate

	Real Estate
Risk-free Rate	4.0%
Risk Premium	2.5%
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 -0.5% standard industry fees and expenses. Premium for opportunistic real estate of 3.0% p.a. reflects illiquidity premium, property enhancement skillset and higher leverage of specialist private equity firms, plus 1.0% for our strategy and manager selection.

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.