PRIVATE EQUITY PERFORMANCE IMPROVEMENT - REAL ESTATE ADVISORY

An Alternative Investment Through Market Cycles

Real Estate | An Alternative Investment through Market Cycles

In this three part series, **"Real Estate: An Alternative Investment Through Market Cycles,"** A&M Real Estate Advisory Services team members, Hunt Holsomback (Managing Director) and Hameer Vaid (Senior Director), discuss real estate as an alternative investment asset class and the impact on this asset class over time withstanding different market cycles (currently through COVID-19 and its recovery).

In part one, we discuss events-driven disruption in real estate, our point of view on a thematic framework that remained consistent throughout events, and how real estate investing strategies shifted over time. This framework supports how real estate investors and managers have typically managed their assets through different market cycles.

Additionally, we discuss the impact COVID-19 had on **U.S. multifamily and hotel** sectors of real estate as well as our perspective on recovery within these sectors. A&M Real Estate Advisory has supported its clients through strategies across strategic acquisition, carve-out, distressed disposition, and operational efficiencies during the COVID-19 crisis. As a trusted advisor, we've supported client partners through both bull and bear market cycles by providing deep expertise across real estate investment strategy, financing, merger and acquisition, diligence and restructuring, holding period, and through strategic disposition.

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Real Estate Private Equity Investments

Before discussing the impact of COVID-19 on multifamily and hotel, below is a **basic recap on real estate private equity investing** (its character, strategies, and life-cycle segmentation) to provide context to A&M Real Estate Advisory Services (REAS) team's point of view referenced in the following pages.

Real Estate investments can be fundamentally categorized across two types: debt or equity. Of course, there are hybrid and other complex combinations prevalent in industry; however, for simplicity, we take a textbook definition here. Also, we generally refer to real estate investments from an equity investors' standpoint. Further, real estate investments can be direct or indirect and can be made using either one—or a combination of—syndication (or partnerships), REIT, or development structures, which are aligned to the overall theses supporting debt, equity, or hybrid investments.

The use of debt or equity capital, or a combination of both, determines the **character of the investment**: (a) **free-and-clear** equity investment where investments are made using equity capital only (b) **leveraged** investment where appropriate levels of debt capital is raised from lenders alongside partner's equity capital invested. Real estate firms will typically work with the latter option as **leverage** is key.

Historically, real estate investing served as a go-to-choice for investors seeking a conservative and long-term investment horizon. **Since the late-1980's/early-1990's**, real estate investing attracted the attention of larger-scale investors (institutional, endowments, pension plans, and private equity) who have adopted such investment strategies for their portfolio diversification and enhancement.

Such demand has evolved real estate **investing strategies** to usually fall under: Core, Core-plus, Value-add, and Opportunistic methods (or strategies) of investing. Other prevalent investing strategies include distressed and debt securities.

A brief review of the **risk/reward relationship** across typical real estate investing strategies is as follows:

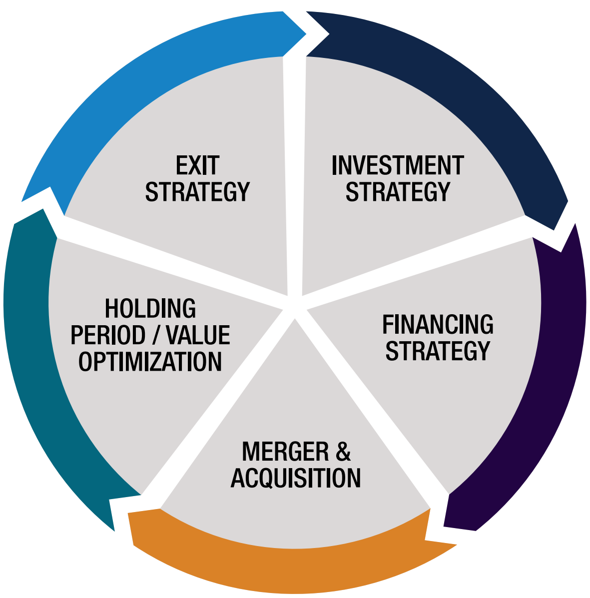
Strategy	Risk / Return measurement	Typical Collateral
• Core	Low	Stable Cash-flow, leased-up asset
• Core-plus	Moderate	Core asset with need for minimal enhancement
• Value-add	Moderate-to-High	Undervalued asset with need for moderate to high levels of enhancement
• Opportunistic	High	High-levels of enhancement, re-development
• Distressed	High	Securities or hard assets purchased significantly below par with one or more financial and operational challenges that need to be addressed
• Debt	Low-to-High	Debt securities (institutions), direct debt investments (lenders), mezzanine financing (option to convert to equity in instances of default), etc.

From a liquidity standpoint, real estate investments are considered passive and less liquid than traditional securities (i.e., stocks and bonds). However, in recent times, there has been an uptick, fueled by investor demands, on how investment managers provide their investors liquidity in real estate.

From a valuation standpoint, real estate investments are measured via key variables, such as asset performance (i.e., net operating income or NOI), capital market inputs (i.e., capitalization and discount rates), and replacement cost.

Despite various types of real estate investing structures, or strategies, the life cycle of the investment can be segmented as follows:

A&M Real Estate Advisory Services Approach



Select Life Cycle Functional Components

- **Investment Strategy**: Market Analysis, Product Selection, Placement, Pitchbook, Roadshow
- **Financing Strategy**: Capitalization (debt and equity), Credit Lines, Working Capital Management
- **M&A**: Pre-acquisition Underwriting, Asset Due Diligence, Acquisition, Deal Closing & Post-close
- **Holding Period/Value Optimization**: Investment/Portfolio Management, Asset Management, Valuation, Finance & Ops, Digital
- **Exit Strategy**: Disposition Strategy, Underwriting, Deal Closing & Post-close

Disruption in Real Estate

Over the past few decades, within the U.S. markets, there have been macro-activities and micro-activities that contributed to the evolution of real estate as an alternative investment class – one that has found equal footing among other notable investment classes such as hedge funds, private equity, private debt, and infrastructure. Nevertheless, real estate continues to attract high-profile capital providers and managers seeking absolute risk-adjusted returns within their overall portfolio by diversifying with real estate investment strategies.

Disruption Over Time

Every time there's an event that impacts consumer purchasing power, there's a corelated impact to the real estate industry. This creates an opportunity for the real estate community to do things differently. Noteworthy events include:

- Creation of commercial mortgage-backed securities **(CMBS)** provided a solution for limited lending practices of the 1980's.
- The **tech bubble** of late 1990's/early 2000, adversely impacted the U.S. economy, according to experts, to the tune of approximately USD 6 trillion. This had a downstream impact on real estate syndication and development creating a need for more sophisticated investment management strategies.
- The global financial crisis **(GFC)** impacted real estate causing foreclosures across the sector, near-zero interest rates, and significant mark-down on net-asset value (NAV).
- **COVID-19:**
    - Caused significant slowdown—in the U.S., fundraising activity declined sharply from approximately USD 83 billion secured in FY 2019, to approximately USD 23 billion as of June-2020 (sources: Preqin and PERE), accumulating significant dry-powder allocated toward real estate investments.
    - Accelerated the pre-COVID-19 slowdown faced in retail due to rise of digital channels in retail. Hospitality experienced a record low in occupancy and average daily rates (ADR). On the flipside, disruption from COVID-19 created a surge in capital allocation toward industrial assets and single-family homes.
    - With lenders holding off on major decisions towards non-performing loan pools, and in some instances on new acquisitions, managers are experiencing longer deal-cycle times keeping capital on the sidelines.

Regardless of the current state, real estate investors, managers, and regulators continue to focus on repositioning to enable stabilization of portfolios – specifically working on maximizing values during the holding period and appropriately at exit (or disposition). The "value drivers" are discussed in more detail in the Thematic Framework section, where we review the fundamentals across supply, demand-drivers, valuation, and capital markets. Additionally, by taking a view based upon performance of an investment's income statement, A&M continues to focus on operational efficiency. From ground up property management, to leasing, to asset management and other support functions, we believe there are areas to continuously improve the net operating income which in turn is key driver of value.

Shift in Investing Strategies and Business Models

With disruption, there has been an opportunity for the real estate community to do things differently, a few relevant callouts:

- **Diversification in syndication** – shift from traditional closed-end fund, or single joint-ventures, to the rise of open-ended funds, separate accounts, co-investments, and now SPACs.
- **Expansion in REIT structures** – prevalence of non-traditional REIT structures (i.e. mortgage, cell-tower, student housing, cold storage, etc.) as an alt. source of financing.
- **Consolidation and M&A** – institutions acquiring niche vertically-integrated platforms providing operating company expertise, private capital solutions, secondaries financing, etc.
- **Adoption of PropTech** – technology in real estate where investors are placing bets in early stage concepts with focused fund raises (e.g. Smart Building, Drone Security, Robotics Process Automation, etc.).
- **Outsourcing** – rise in decentralizing select non-strategic and tactical middle and back-office functions to third-party service providers.

Below is a summarized timeline view of major disruptions that impacted the real estate industry over the past 40 years.

Selected Events-Driven Disruption in Real Estate

1980s to Late 1990s / Early 2000s

- Prominence of real estate (RE) as an alternative investment asset class
- Organization of real estate governing councils
- Limited lending, creating the CMBS
- Tech bubble
- Private placements across RE equity and debt investments

Early 2000 to 2019

- Expansion of RE investment strategies (core-to-distressed)
- Global financial crisis & recovery
- Shift in traditional investing strategies
- Change in platform model structures
- Consolidation and M&A
- Adoption of PropTech, RPA, AI
- Expansion of secondaries financing
- Focus on data & analytics (on-demand access)

2020 - Present

- **COVID-19 related slowdown**
- 2020 focus on liquidity
- 2021 focus on recovery
- Rebalancing of equity dry powder:
  - Continued re-allocation of capital across major real estate asset classes
  - Placement of key bets across value-add, build-to-core, and distressed assets

Thematic Framework

Despite event-driven disruptive cycles the past few decades, thematically, the framework for analyzing and investing in real estate has remained a constant and with each market-cycle, there are underlying sub-components. Key elements of the thematic framework include:

- **Supply-side factors**: What asset classes are underweight propelling shift in capital allocation?
- **Demand drivers**: Which asset classes are consumer behavior trending toward?
- **Valuation**: How do you determine price equilibrium given supply and demand factors?
- **Capital markets**: Bull or bear market, what capital resources may be available against the investor's cost of capital?
- **Property fundamentals**: How best can we prioritize location strategy and management capabilities to maximize yields (IRR, MOIC, etc.)?

In analyzing the impact of the economic slowdown caused by COVID-19, we've summarized the following framework and responses to fundamental underlying questions.

Thematic Framework | Investing in Real Estate Through Market Cycles

A&M REAS perspective: COVID-19

Evolving sub-drivers based upon market-cycle

1. Supply-side Factors

- Alignment of foreign capital toward build-to-core opportunities
- Micro bets on "drive to leisure"
- Platform capabilities of real estate managers and service providers(i.e. in/out-sourced)
- Re-positioning of inventory – primarily, office, retail and select housing
- Uptick in development of non-traditional RE asset classes

3. Valuation

- Focus on intrinsic values, shift away from future potential cash-flows
- Discounting is key; strong correlation to WACC preferred
- Terminal cap rates impacted by weighting between debt and equity – creative financing across capital stack
- Limited precedent transaction comps
- Repositioning highest and best use

Price Equilibrium

PROPERTY FUNDAMENTALS

1. **Location:** recently, smart assets with access to "eat-play-work" – shift away from 24-hr. and 18-hr. cities
2. **Landlord capability:** operational expertise and efficiency to enhance value
3. Relative matching to **underwriting post Year 1** of acquisition
4. Tracking to investment **IRR & MOIC**

2. Demand Drivers

- Evolving return-to-work and remote working protocols
- Consumer buying behaviors across utility asset classes (i.e. office, retail, housing, and hospitality)
- Reallocation of institutional bets from CBD and metropolis to tertiary markets
- Demand for non-traditional RE asset classes

4. Capital Markets

- Bull or bear scenario vs. investors' cost of capital
- Equitable mix of equity and debt capital based upon investment thesis
- Variety of positions across the capital stack to supplement risk-and-reward
- Key bets value-added and distressed positions due to restructuring or Chapter 11 filing

Evolving sub-drivers based upon market-cycle

COVID-19 Impact and Outlook

Big Picture

2020 Focused on Liquidity; 2021 Focused on Recovery

In this section, we discuss two of the major asset classes: U.S. multifamily and hotel, as it relates to the impact of COVID-19 with a preliminary outlook on recovery. The following provides A&M REAS' perspectives on the evolving market conditions aimed to supplement available market intelligence on where future bets may be for multifamily and hotel.

Multifamily: Pre-pandemic development and re-development are now in spotlight on the supply-side. This is feeding the evolving demands from consumers for safer, larger, and easily accessible residential stock. Sub-sector specific, affordable multi-family housing maintained strong occupancy with a surge in demand for single family homes through the pandemic with migration to the suburbs and secondary markets. Additionally, despite the increase in unemployment rates, affordable housing has held steady occupancy levels due to rent forgiveness, stimulus payments, etc.

Hotel: Premium full service hotels have deployed significant cost-curtailment measures over the past year setting up the basis for recovery. Non-premium select-service and economy hotels that cater to transient customers are seeing a recovery; however, large city center business class hotels continue to struggle due to limited group and conference business with limited exit strategies barring distressed sales. Occupancy levels in 2020 dropped to a record low at ~44%, a decrease of 33% over 2019 occupancy levels.

A Deeper-Dive | Multifamily

U.S. Multifamily has demonstrated resiliency during COVID-19 with investors, operators, and developers maintaining their positions on providing a healthy supply despite the effects of the pandemic.

Supply-side

- From 2008-2012, approximately 453,000 units across newly built communities have been delivered across U.S. multifamily (source: CBRE); averaging ~91,000 new units completed per year.
- That statistic, from 2013 to 2019, is approximately 1.6 million units across newly built communities delivered (source: CBRE); averaging ~231,000 units completed per year.
- Similarly, in 2020, approximately 280,000 newly completed units were delivered (source: CBRE):
  - Equating to ~21% (or ~49,000 units) higher than the seven-year average (2013-2019).
  - Approximately 209% (or ~189,000 units) higher than the five-year average (2008-2012), which included the aftermath from the GFC.
- Net absorption for 2020 has been approximately 191,000 units (source: CBRE).
- Additionally, allocation of equity dry powder toward multifamily has held up well as compared with office and retail, with and increased reallocation (of dry powder) toward industrial, logistics, and life sciences.

Demand Divers

- **Population outmigration 2020** – with the rise of remote work and hybrid work protocols backed by the employer, consumer behaviors seem to be shifting, yet again, moving to suburban, secondary, and tertiary markets keeping lower cost of living, extra living space, and accessibility at the forefront.
  - Based upon on-the-ground research from North American Moving Services: Illinois, New York/New Jersey, and California are states with highest outbound moves.
  - Same report suggests that states: Idaho, Arizona, Carolinas, Tennessee are the top grossers for inbound moves followed by Florida, Colorado, and Texas.
- **Unemployment** – with U.S. unemployment rates closing at approximately 6% at the end of March 2021, a key driver continuing to impact demand will be residential housing stock in lower cost and tax locations, or alternatively increased allocations toward affordable/workforce housing.
- **Average rents** – excluding three gateway markets (San Francisco, San Jose, and New York) that are skewing the national U.S. average, year-over-year decline in rents has been a modest ~1.3% (source: CBRE), indicating resiliency within the multifamily sector.
- **Last-mile fulfillment** – with higher demand in the industrial and logistics sectors, trends are indicating supplementary demand for workforce housing.

COVID-19 Impact on Multifamily

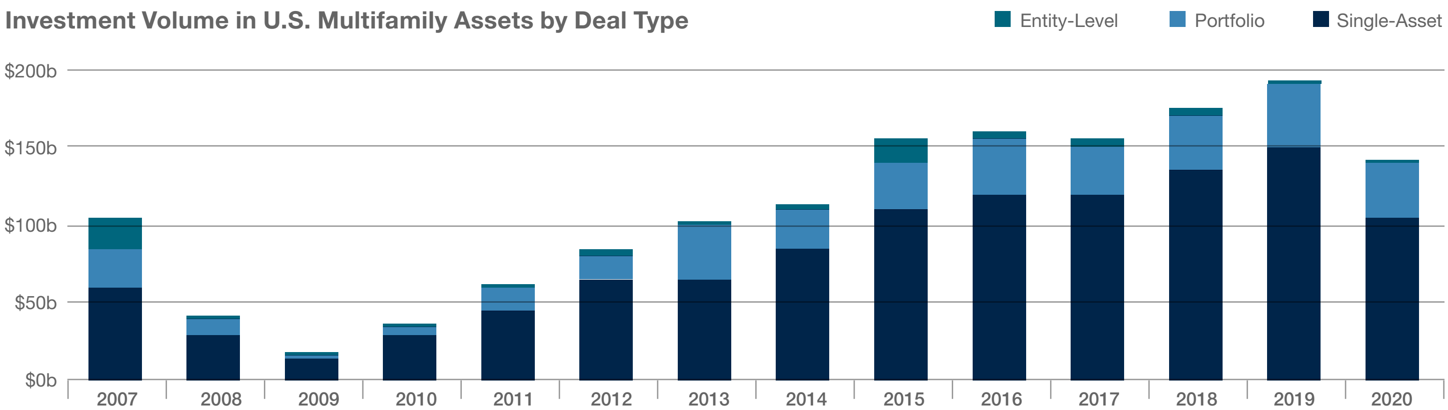
As we analyze the current state of the multifamily sector, a few considerations around the **supply-side** continue to be at the forefront:

- Investors and managers are mitigating higher vacancy levels in class A assets by repositioning units that provide remote working spaces.
- Tertiary markets continue strong on the delivery of multifamily housing stock catering to job growth created pre-pandemic – a trend developers project will return on a hybrid basis creating demand.
- Focus on repositioning of branded hotel assets with fully managed hotel and apartment inventory continues to attract investor attention.
- Smart building and other PropTech continues to gain traction in affordable and student housing stock.
- Large-scale multifamily portfolios with higher vacancy levels, and conservative reprojections, within the metro-markets, are attracting investor attention on disposition or recap scenarios.

Deal Volume and Capital Markets

As we review deal volumes in U.S. multifamily assets, we note continued activity in single asset deals closing in at ~$100 billion in 2020 (source: CBRE) despite the slowdown from COVID-19.

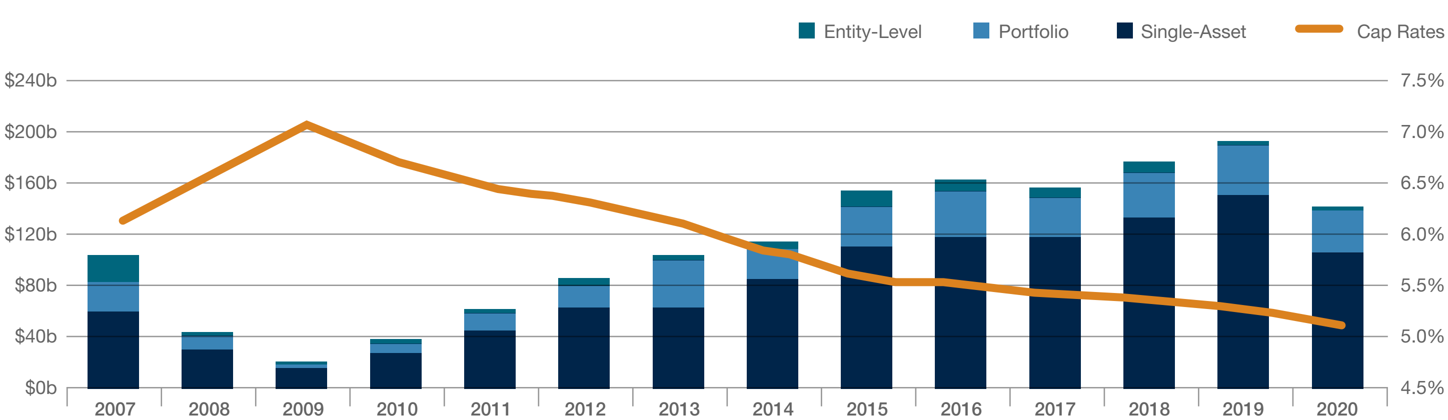
Investment Volume in U.S. Multifamily Assets by Deal Type



Source: CBRE

U.S. Multifamily Cap Rates:

- Class A rates have ranged between 3.75%-5.75% through summer of 2020 (source: CBRE)
- Select markets such as Atlanta, Baltimore, Dallas/Ft. Worth, Denver gaining in values due to lower cap rates compared to 2H 2019
- Correspondingly: NYC, Orlando, and Seattle experiencing lower valuation due to higher cap rates compared to 2H 2019



Source: CBRE Research, Real Capital Analytics, Q4 2020.

A Deeper-Dive | Hotel

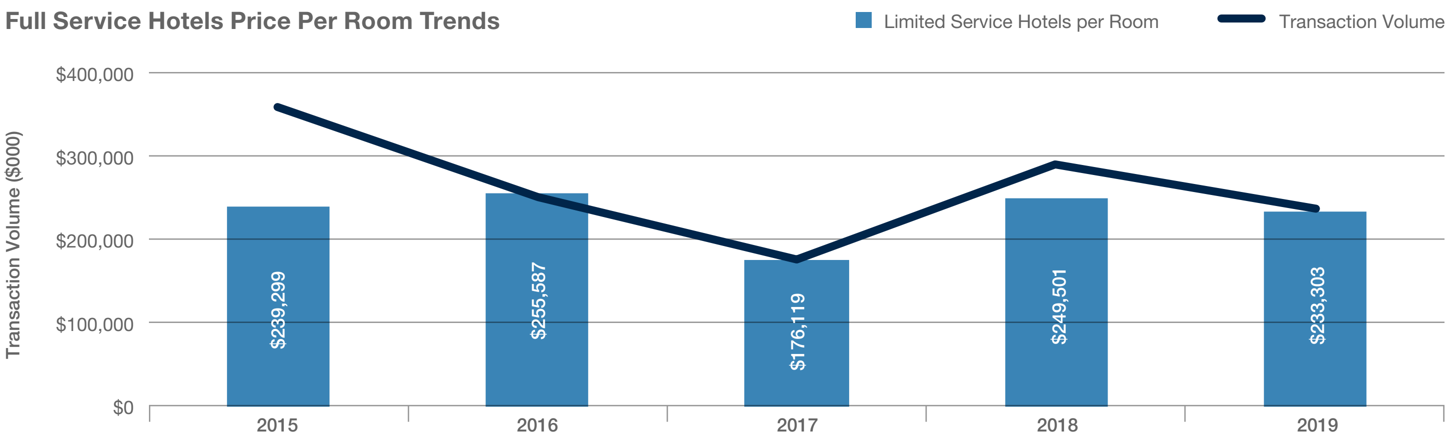
U.S. hotels have traditionally held strong occupancy levels (62%-70%) pre-COVID with 2020 driving down demand (or occupancy levels) to approximately 44%, down 33% from 2019 levels, across sub-classes in hotel (i.e., luxury to independents). The fall in demand has strong-armed most brands to pivot their strategies to cost reduction, liquidity management and while sale of distressed assets have been limited to date, activity is increasing. A degree of cost reduction may likely be sustainable in the long run, and a necessary correction, in terms of operating efficiency that was to some extent neglected given the nearly 10 years of quarter-over-quarter growth in RevPAR.

Supply-side and Demand Drivers | Five Year Overview: 2015 to 2019

Supply-side	Demand Drivers
From 2015 to 2019, average rooms available have been approximately **5.1 million** (source: Cushman & Wakefield, STR) creating supply (# rooms x 365) of approximately **1.8 billion average room nights per year.**	Correspondingly, average annual demand for the same period has been approximately **1.2 billion room nights** (source: Cushman & Wakefield, STR) per year which equates to **average occupancy levels** (room nights demanded ÷ room nights in supplied) of approximately **65.9%**.
For the same period, **average growth** in room nights supply has been approximately **1.5%** and compounded annual growth rate **(CAGR)** has been **~1.3%**.	Independently, for the same period, **average rooms nights demanded** grew by approximately **2.1%** with **CAGR of ~1.5%**.

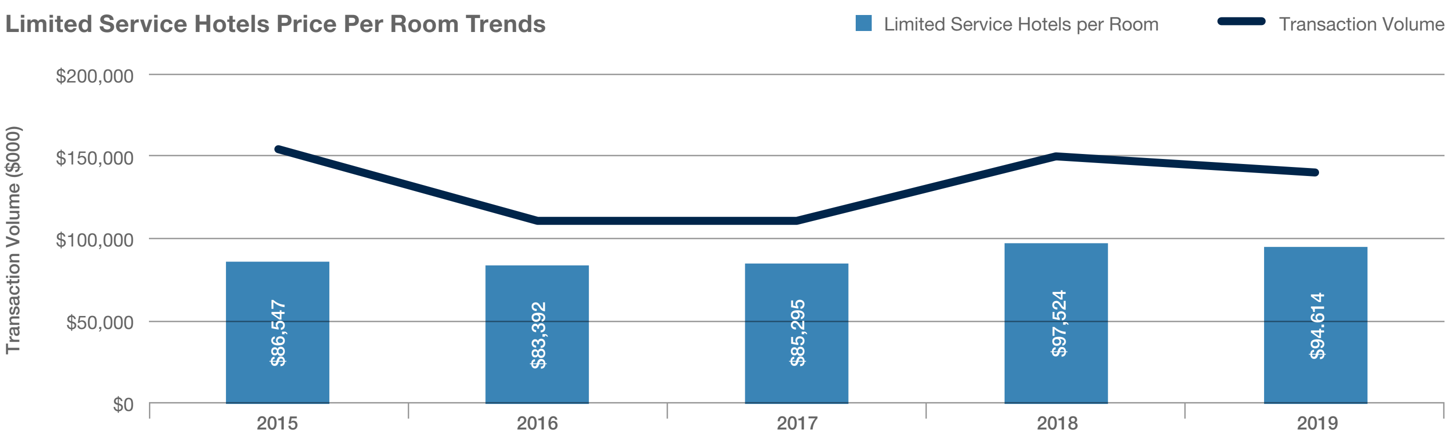
- Interestingly, this comparison may also indicate that while occupancy levels trended close to 66%, and the demand curve grew at healthy rates, inherent excess demand may still not have been met due to limiting factors.
  - In comparing the average rooms supplied of ~5.1 million per year against average rooms demanded of ~1.2 billion per year, each room was utilized approximately 240 times per year indicating a gap felt by hotels at large in pre-pandemic times.
- In part, that gap can be addressed by ancillary supply to the end customer via platforms like Airbnb, VRBO, etc.
- The following graphs provide indicative price per room trends for the stated five-year period:

Full Service Hotels Price Per Room Trends



Source: RCA / Cushman & Wakefield

Limited Service Hotels Price Per Room Trends



Source: RCA / Cushman & Wakefield

COVID-19 Impact on Hotels and Recovery for the Asset Class

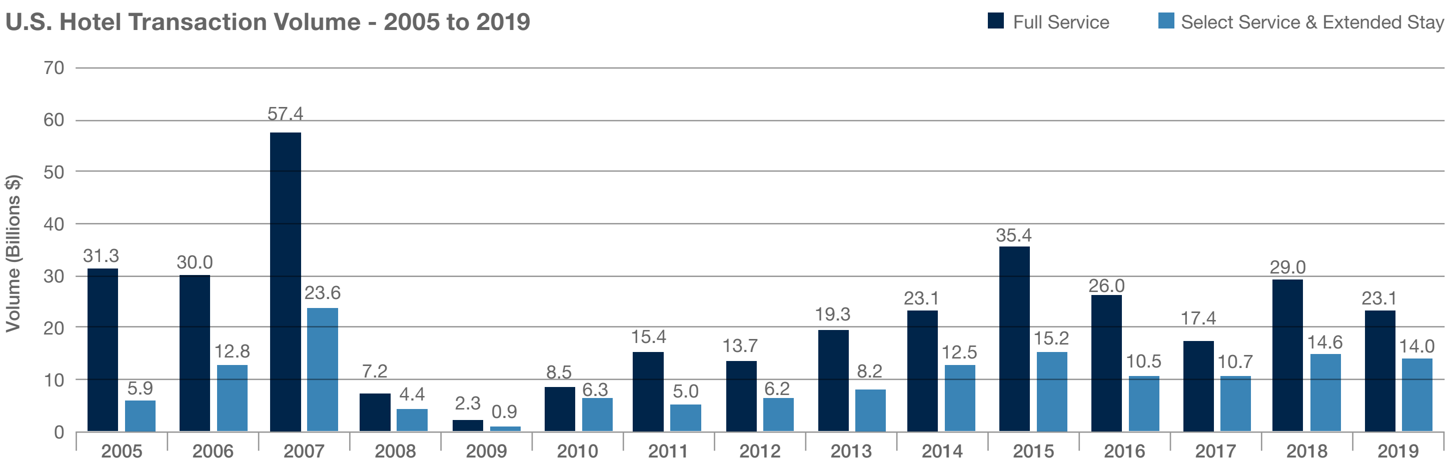
As we analyze the current state of the hotel industry, a few considerations may help with the debate on when/how hotels will make a recovery to pre-pandemic times:

- Capitalizing on pent-up demand for work or leisure travel (with the former now possible from destinations away from home and the office), is a Hybrid Lifestyle Model.
- Adopting pandemic-style safety measures into investment thesis.
- Addressing price competition arising from ancillary platforms (i.e., Airbnb, VRBO, etc.).
- Development and redevelopment of net new inventory in opportunistic markets.
- Acquisition of assets in premier, secondary, and tertiary markets at discount to replacement cost.
- Repositioning of assets in foreclosure and distress.
- Focus on resort and drive to destinations that may recover faster, with business travel recovering; however, conference and convention travel will likely face slower recovery.
- Optimization of cost to allow for revenue discounting while creating room for margin growth.
- Redesigning of existing operating models, or platforms, across people, process, technology, governance and organization.

Deal Volume and Capital Markets

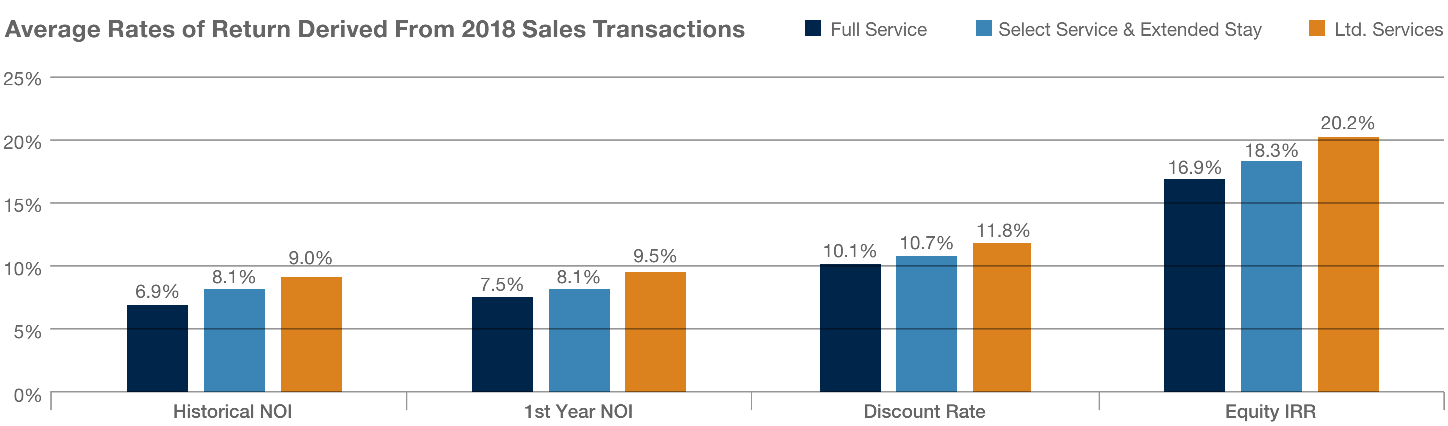
As we reviewed deal volumes over the past 15 years, a few key statistics indicated that bringing hotels back to FY 2018/2019 levels will require a disciplined approach by the investor community—one that believes in the key fundamentals of hotel sub-classes. Especially, given a unique upcoming model affected by new remote working possibilities.

U.S. Hotel Transaction Volume - 2005 to 2019



Source: RCA / Cushman & Wakefield

Average Rates of Return Derived From 2018 Sales Transactions



Source: HVS

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Capitalization Rates Derived from Sales Transactions*

Property Type	2018		2017		2016		2015	
	Average (%)	Range (%)	Average (%)	Range (%)	Average (%)	Range (%)	Average (%)	Range (%)
Full Service Incl. Luxury	6.9	3.8 – 11.0	7.5	2.6 – 10.8	7.0	3.3 – 13.6	6.4	2.4 – 9.9
Select Service & Extended Stay	8.1	4.5 – 11.0	8.6	4.0 – 15.2	8.3	6.5 – 10.3	8.2	5.0 – 14.0
Limited Service	9.0	5.0 – 14.3	9.0	5.8 – 12.8	9.1	5.1 – 17.7	9.2	1.1 – 13.3

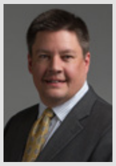
Source: HVS

Hotels appraised by HVS at the time of sale

Key Takeaways

- While there is increased focus on the demand for multifamily during COVID-19, we believe a keeping a pulse on the supply-side may provide a stronger correlation as investors think about recovery – one that will provide a competitive advantage based upon the type of multifamily stock competed and supplied.
- Notable sub-sectors on the housing watchlist include student housing and affordable housing given there is an implied shield around education and demands of the workforce when faced with a down-market.
- With the rise in remote work and hybrid work protocols backed by the employer, consumer behaviors seem to be shifting, yet again, moving to suburban, secondary, and tertiary markets keeping lower cost of living, extra living space, and accessibility at the forefront.
- We are forecasting that a Hybrid Lifestyle Model – one where work, remote learning, and leisure can be accomplished at the same time while away from home, school, or the office – will promote a different supply and demand opportunity for hotels.
- Pricing will continue to compress (luxury destinations in the short run) with “one-stop-shop” style hotel, or ancillary, inventory coming to market.
- Lifestyle brands continue to take market share of an increasing hotel supply base as major brands continue to invest in the development of their lifestyle portfolios.
    - A&M forecasts ~8.8% growth in revenue over the next 3-5 years for luxury hotels and ~20.7% increase in revenue over the next 3-5 years for upscale/midscale hotel segments.
- As the hospitality market returns, how will changes in external factors impact demand among key customer segments.
- Lenders continue to remain patient toward non-performing loan pools with keen focus on due diligence on business plans for new issuances.
- Investors and developers are back at the drawing board seeking opportunistic plays, and first mover advantages, to harness the evolving consumer behaviors and buying patterns.

Key Contacts:



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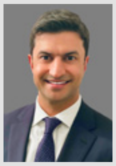

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