PRIVATE REAL ESTATE STRATEGY UPDATE

EXECUTIVE SUMMARY

Seven months into this COVID-19 crisis, we have a good sense of how real estate is weathering this storm, and how it will perform over the next cycle.

The asset class faces significant challenges. Retail, for instance, will probably continue to struggle. However, we also see attractive opportunities for investors within commercial real estate. Moreover, the asset class's inflation-hedging characteristics could contribute to returns over the next 5–10 years.

We anticipate the following themes will be critical for real estate allocators over the next cycle:

1. ***Balancing Secular Growth with Stable Income*** – Properties with leverage to secular growth trends, like e-commerce (e.g., warehouses), should be long-term winners. Meanwhile, traditionally defensive property types like multifamily housing should continue to generate stable returns. Managers focused on these markets are positioned to outperform.

2. ***Looking Beyond Superstar Cities*** – Sunbelt and tier 2 city–focused players could continue to outperform as demand shifts away from high-price gateway metros like New York and San Francisco. While geographic exposure is harder for allocators to target than sector exposure, it could drive performance at the margins.

3. ***Diversifying into Non-Core Property Types*** – While core real estate funds will anchor most clients' real estate allocations for the foreseeable future, we see growing opportunities outside of the four traditional core property types: retail, office, multifamily, and industrial. Allocators that diversify into "extended core" assets, a category that encompasses life sciences properties, self-storage, senior housing, and student housing properties, among others, could be rewarded over the next cycle.

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Contextualizing the Asset Class – Private Real Estate's Role Over the Next Cycle

Private real estate should play three key roles in allocators' portfolios:

Firstly, it should offer competitive total returns. Since its 1977 inception, the NCREIF Open End Diversified Core Equity (ODCE) real estate index, the most widely used benchmark in the private real estate market, has returned 7.4% per year. While we anticipate returns could be lower over the next cycle – our capital market expectation is for sub-6% private real estate returns over the next decade – asset class performance should still prove competitive in a lower-return world.

Secondly, it should generate attractive current income. Income has accounted for more than 80% of the ODCE's gross returns since inception. Today, the index yields over 4%. That compares to a ~1.2% yield on core U.S. fixed income, as represented by the Barclays Aggregate Index.

Finally, it should offer inflation protection. Commercial real estate owners can reprice leases to capture inflation. Moreover, property prices tend to climb with broader price levels. While assets like commodities and TIPS also offer inflation insurance, commercial real estate has historically delivered this protection with less volatility and higher returns than those alternatives, respectively. These advantages have earned commercial real estate – both private real estate funds and listed real estate investment trusts (REITs) – a key role in our inflation protection portfolio sleeves.

Real estate inflation hedging characteristics were less significant over the last cycle, as Consumer Price Index (CPI) Inflation compounded at a muted 1.7% rate since 2009. However, we believe the asset class's upside in inflationary environments could be more significant over the next business cycle.

Inflation Outlook – Inflation Risk Bears Watching

Inflation has plunged over the last six months, driven by pockets of deflation in categories including travel and apparel. Meanwhile, longer term inflation expectations remain subdued. While 10-year TIPS breakevens have rebounded from their March lows, they remain meaningfully below 2%.

Over the short term, low inflation expectations are justified. Elevated unemployment should lead to subdued inflation. Moreover, industries ranging from oil refineries to restaurants are emerging from this crisis with excess capacity. Capacity underutilization tends to be deflationary. However, these short-term crosscurrents could be masking longer term inflationary pressures. We see long-term inflation overshoot risk increasing for three reasons:

Firstly, the Federal Reserve's recent embrace of average inflation targeting has eased a key constraint on inflation. This change to the Fed's decision-making framework will allow the central bank to let the economy run hot, accepting >2% inflation over the late innings of the next cycle in order to compensate for below-target inflation earlier in the cycle.

Secondly, looser fiscal policy could increase inflation overshoot risk. Policy makers on both sides of the aisle appear increasingly comfortable with deficit-funded stimulus. With unemployment above 8%, the short-term reflationary impact of fiscal stimulus could be limited. However, over a complete business cycle, looser fiscal policy should have a more meaningful impact on price levels.

Finally, deglobalization could prove inflationary. We've already seen signs of this as international supply chain bottlenecks and tariffs contributed to durable goods' price increases over the last year. If deglobalization accelerates, this could compound the reflationary impulses from loose fiscal and monetary policy.

While we're not forecasting runaway inflation tomorrow, we believe these developments could strengthen the case for

allocating to inflation beneficiaries. Loose fiscal policy, dovish monetary policy and trade conflict should all add to inflation overshoot risk. If these drivers lead to meaningful purchasing power erosion over the next cycle, allocators could be rewarded for holding real assets like real estate.

State of the Sector – Looking Back on the Last Six Months

Six months into this crisis, the real estate cycle has clearly turned. Green Street's Commercial Property Price Index (CPPI) shows commercial property values falling ~11% from pre-COVID levels.[1] Delinquency rates on CMBS issued after 2009 reached 10.3% in June, ending the month just shy of their 2012 peak.[2] At its peak, the redemption queue for ODCE funds has climbed to an all-time high of >$14 billion.[3] Meanwhile, property-level liquidity has evaporated: second quarter domestic commercial real estate transaction volumes fell 68% year-over-year, with liquidity on the most stressed property types, such as enclosed malls, completely drying up.[4]

Private real estate marks have been slow to reflect these challenges. True to its history as a smoothed lagging indicator, the NFI ODCE Index is only down ~60 bps through the end of the second quarter. This is consistent with research showing that appraisal-based valuation marks often take several quarters to reflect market stress.[5] Our analysis suggests ODCE Index returns will end up relatively flat over calendar year 2020.

Looking beneath the surface, this has been a tail of two cycles. Defensive property types, like multifamily housing, and digital services–leveraged property types, like warehouses and data centers, have proved resilient, while in-person services exposed property types like malls have been most impacted. This should drive performance dispersion over the remainder of 2020.

Our manager lineup is tilted toward multifamily relative to the NFI ODCE index. This should support relative performance through this crisis. However, our managers are not immune to the struggles facing retail and hospitality.

Core Commercial Real Estate – Re-Underwriting Our Assumptions for the Four Core Property Types

The current crisis should lead to continued industrial and multifamily outperformance, while weighing on the already struggling retail sector. We've already seen this in the Green Street Commercial Property Price Index numbers:

Figure 1

Green Street CPPI - Sector Performance

	Industrial	Multifamily	Office	Retail*
Post Crisis	-5.0%	-10%	-9.0%	-17.5%
TTM	2.0%	-4.0%	-7.0%	-23.5%

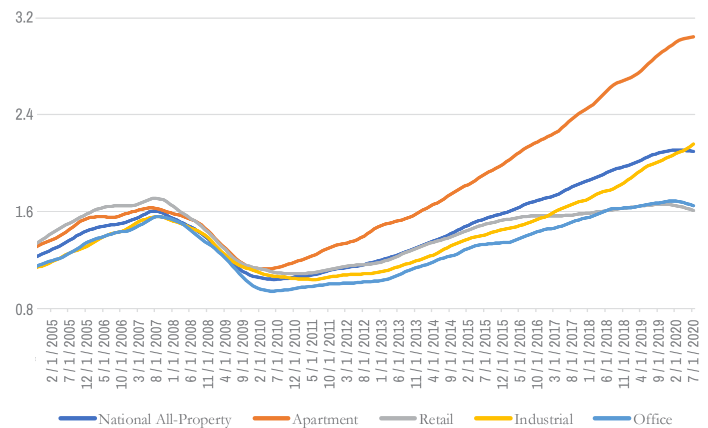
*Retail: Malls (50%) and strip Retail (50%)

Source: Green Street CPPI as of 8/7/20; Highland Associates;

This represents an acceleration of prevailing price performance trends:

Figure 2

RCA CPPI - Sector Performance



Source: RCA CPPI as of 6/30/20; Highland Associates;

[1] CPPI | Commercial Property Price Index. Greenstreetadvisors.com. (2020). Retrieved August 31, 2020, from https://www.greenstreetadvisors.com/insights/CPPI.

[2] Clancy, M. (2020, September 1). CMBS Delinquency Rate Continues Retreat from Near All-Time High. Retrieved September 5, 2020, from https://info.trepp.com/trepptalk/cmbs-delinquency-rate-continues-retreat-from-near-all-time-high.

[3] Peterson, J. (2020, May 29). US Core Real Estate Funds' Redemption Queues Reach $14.4bn. Retrieved September 5, 2020, from https://realassets.ipe.com/news/us-core-real-estate-funds-redemption-queues-reach-144bn/10045900.article.

[4] US Transaction Volume Plunges in Q2: RCA Report. (2020, July 27). Retrieved September 5, 2020, from https://www.rcanalytics.com/usct-overview-q2-2020-covid/.

[5] Cho, H., Kawaguchi, Y., & Shilling, J. D. (2003). Unsmoothing Commercial Property Returns: A Revision to Fisher-Geltner-Webb's Unsmoothing Methodology. Journal of Real Estate Finance and Economics, 27(3), 393-405. https://doi.org/10.1023/A:1025898325952.

Figure 3

Sector Outlook

	Industrial	Multifamily	Office	Retail*
Near Term Outlook	**Strong** Climbing ecommerce penetration is driving demand. Inventory restocking is also positive.	**Mixed** Gateway city rent pressure and rising unemployment are challenging. However, operating results remain healthy.	**Mixed** Long lease terms have insulated office properties over the early innings of this crisis. However, the decline in new lease activity is concerning.	**Challenged** Closed air malls saw crisis period rent collections fall to <30% of pre-crisis levels. Rent collections have partially recovered bur remain historically depressed.
Long Term Outlook	**Strong** Ecommerce only represents 16% of total retail sales. If B2C sales continue to grow at a high teens CAGR warehouse owners will be a key beneficiary.	**Strong** While high price metros may struggle, stable demand and government support in the form of agency financing should contiue to drive healthy returns for the broader sector.	**Mixed** Survey results show that COVID-19 will drive long term work from home adoption, hurting office space demand. However, de-densifacation trends could offset some of these headwinds.	**Challenged** Before this crisis, retail property owners were struggling with overcapacity. Today, as anchor tenants like Neiman Marcus and J.C. Penney go bankrupt and accelerate store closures, this could come to a head.

Source: Highland Associates

Industrial

Industrial commercial real estate has been resilient through this crisis, building on a record of outperformance that stretches back to 2013. Much of this comes down to the warehouse sector's leverage to e-commerce demand. Census Bureau data show U.S. e-commerce sales grew ~$65B (~45%) year-over-year over the second quarter of 2020. According to research from CBRE, every $1 billion increase in business-to-consumer sales requires an additional 1.25 million square feet of warehouse space.[6]

A renewed focus on supply chain resiliency could also be positive for the sector. Just in time—inventory management techniques' failures in the early stages of this crisis have led to inventory restocking. Warehouse owners could benefit if this preference for higher inventory levels has staying power.

Within the sector, properties in the Northeast and West Coast markets have been relative winners. Meanwhile, Midwestern players and properties with significant exposure to brick-and-mortar retail clients have lost business. Managers we've spoken to see that relative performance trend continuing.

Overall, we expect industrial properties to continue to outperform.

Multifamily

The apartment sector has held up well through this crisis. Rent collections fell 3% year-over-year over April, but only 1% year-over-year over July, per the National Multifamily Housing Council Rent Payment Tracker.[7] Meanwhile, multifamily cap rates have remained anchored near 5%.

There could be some near-term headwinds as supplemental unemployment insurance benefits expire. However, the higher rent class A and B properties most ODCE funds focus on should be insulated from these headwinds. Through August, ~90% of A and B rent was collected.[8]

Within multifamily, lower cost suburban properties could outperform higher cost urban properties as residents leave expensive gateway cities. While funds with multifamily exposure to higher cost gateway markets like San Francisco and New York will likely be challenged near term, the broader multifamily sector appears positioned to maintain its status as a defensive, resilient component of the portfolio through this crisis. The multifamily sector's access to agency financing via Freddie Mac and Fannie Mae could also support performance through this crisis, by insulating property owners from some of the credit market challenges facing other commercial real estate investors.

Office

The office sector faces significant challenges. Longer lease terms have insulated sector investors from the early effects of this crisis, with office owners reporting modest 1.5%-2.5% year-over-year declines in rent growth over second quarter 2020, according to Real Estate Research Corporation.[9] However, new leasing activity has declined ~80% over

[6] *Wang, T. (1Q 2020). ODCE: Major Shifts in Sector Allocation Underway. Retrieved September 5, 2020, from https://www.ncreif.org/globalassets/public-site/research/member-contributions/odce-2019q4.pdf.*

the second quarter, while work-from-home adoption has increased, signaling trouble on the horizon.

Work-from-home (WFH) adoption will be key for the sector over the next cycle. Atlanta Fed survey data show employers anticipate ≥1 day a week WFH penetration will climb from 9.7% in 2019 to 27% post-pandemic, while full-time work remote penetration climbs from 3.5% to 10%.[10] Similarly, Gensler survey data show 56% of employees now want to work from home at least one day a week, while 12% of employees want full-time remote arrangements.[11] While de-densification efforts could offset this projected ≥10% demand shock short term, the longer-term impacts of WFH could be significant.

Within the sector, the current environment favors suburban office parks over central business district (CBD) properties in gateway cities like New York, Chicago, and Los Angeles. However, over a longer time horizon, CBD assets should benefit from the same supply constraints that drove outperformance over the last cycle.

Office properties will likely be challenged near term. However, opportunistic managers may be able to capitalize on dislocations within the sector.

Retail

The retail sector was struggling with overcapacity issues before this crisis, with ~5x as much retail square footage per capita as Europe.[12] We anticipate much of this capacity will ultimately have to be closed for rents to stabilize.

Within retail, open-air shopping centers and strip malls could prove relatively resilient, while closed-air malls should struggle most. Some managers have argued that over 75% of the country's >1,100 malls will close over the next couple years as the industry right-sizes. Bankruptcies of anchor tenants like Neiman Marcus and JCPenney could bring this crisis to a head, as store closures trigger co-tenancy clauses in other leases.

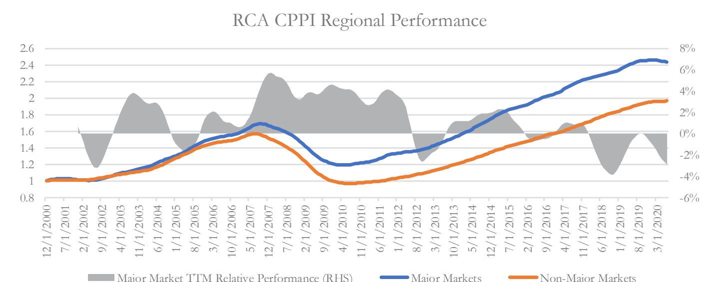
Near term, financing issues could hurt valuations for even healthier retail properties. Creditors' reticence to underwrite retail loans means even high-performing property sales will often require all-cash bids.

These headwinds make retail a difficult allocation. ODCE funds will likely struggle to reduce retail exposure near term. For the most exposed funds, this could lead to sustained exit queue pressure and a persistent drag on performance.

Core Commercial Real Estate – Re-Underwriting Our Assumptions Across the Regions

The 2008–2015 period favored property portfolios tilted toward gateway cities like Boston, Chicago, Los Angeles, and New York City. However, over the last ~5 years, smaller markets have begun to gain traction:

Figure 4



Source: RCA CPPI as of 6/30/20; Highland Associates;

[7] NMHC Rent Payment Tracker. (n.d.). Retrieved September 1, 2020, from https://www.nmhc.org/research-insight/nmhc-rent-payment-tracker/.

[8] Willett, G. (2020, August 24). Apartment Rent Payments Hit 90% in August's Third Week: RP Analytics. Retrieved September 5, 2020, from https://www.realpage.com/analytics/apartment-rent-payments-hit-90-augusts-third-week/.

[9] Molloy, J. M. (2020, June 30). Implications of the COVID-19 Crisis for Commercial Real Estate Values. Retrieved September 9, 2020, from https://www.situsamc.com/insights/implications-covid-19-crisis-commercial-real-estate-values.

[10] Altig, D., Barrero, J. M., & Bloom, N. et. al. (2020, May 28). Firms Expect Working from Home to Triple. Retrieved September 4, 2020, from https://www.frbatlanta.org/blogs/macroblog/2020/05/28/firms-expect-working-from-home-to-triple.

[11] Gensler Research Institute, Briefing #1: Back to the Office. Retrieved September 9, 2020, from https://www.gensler.com/uploads/document/695/file/Gensler-US-Work-From-Home-Survey-2020-Briefing-1.pdf.

[12] Scruggs, G. (2019, December 16). The Unmalling of America. Retrieved September 5, 2020, from https://www.lincolninst.edu/publications/articles/2019-12-unmalling-america-municipalities-navigating-changing-retail-landscape.

These trends should accelerate near term. With amenities shut down, office jobs going remote, and public transit viewed as unsafe in the current COVID environment, many are fleeing high-cost urban markets, hurting downtown office space and apartments in New York City, San Francisco, and elsewhere. Research from Heitman and RealPage shows the 20 worst performing multifamily markets in the country have average rents >60% above the national average.

While the most severe urban rent declines should prove transitory, the tailwinds boosting non-gateway markets could have more staying power. The demographic wave that supported gateway market fundamentals is waning, as millennials age into their 30s. Growing acceptance of work from home is reducing the commuter penalty associated with living farther from central business districts. And the trend of large New York City, San Francisco and Los Angeles employers shifting their footprints to favor lower cost of living and lower tax Sunbelt markets is only accelerating, further weighing on gateway city demand.

While the historic advantages of gateway city properties, including relatively liquid markets and high barriers to entry, will not dissipate, we believe tilts away from gateway cities could be rewarded over the next cycle.

Non-Core Commercial Real Estate – Looking Outside the Traditional Four Sectors

Investors are increasingly looking beyond the four traditional core property types.[13]

This is reflected in recent changes to the ODCE Index inclusion rules. In 2019 NCREIF amended its criteria to allow ODCE funds to invest up to 25% of gross assets outside of the core property types.

In a sense, this represents private markets catching up with public markets. Over the last 20 years, the REIT market's property type exposure has gone from ~80% core to ~50% core. This growing non-core tilt has helped REITs outperform benchmarks like the ODCE Index. Green Street Research shows non-core REITs returning ~12% while core REITs returned ~6% between second quarter 2008 and second quarter 2018.[14] Over the same period, the ODCE Index returned 5.3% annualized while the FTSE NAREIT All Equity REIT Index returned 8.3% annualized.[15]

While we're no longer in the first inning of this shift to non-core real estate, allocators can still benefit from a rich opportunity set outside of the four core sectors. Life sciences real estate, senior housing, self-storage, and single-family rentals, for instance, could represent attractive opportunities today. Moreover, we're seeing some opportunities further afield in the real asset space. Data centers, renewable power, and logistics infrastructure, for instance, may prove complementary to core properties in this environment.

Many of these non-core assets fill similar stable income generating roles; they are just less established relative to their core counterpart. Life science properties, for instance, are less cyclical than traditional office properties. The sector saw net operating income (NOI) grow through the Global Financial Crisis, while broad office NOI contracted. We anticipate a similar divergence through this crisis. Yet life science properties are under-owned by core funds, with an investor base dominated by opportunistic managers and REITs. Allocators that recognize this opportunity may be able to earn attractive returns, while diversifying away some of the business cycle exposure we've seen from traditional core sectors like office and retail.

There are challenges associated with adding exposure to non-core property types. Evergreen and open-ended funds are far

[13] *NCREIF Research. (2019, May 22). ODCE Index Policy Changes Webinar. Retrieved September 4, 2020, from https://www.ncreif.org/globalassets/public-site/webinar--education-page-images/webinars/1q2019/odce-index-policy-changes-webinar-may-22-2019.pdf.*
[14] *Kirby, M. (2018, September 19). Non-Core Sectors Come of Age, CPPI Expanded. Retrieved September 4, 2020, from https://www.greenstreetadvisors.com/insights/blog/non-core-sectors-come-of-age-cppi-expanded.*
[15] *Some of this outperformance came down to leverage. REITs tend to carry more debt than private real estate funds. That higher gearing was rewarded during the 2008–2018 bull market. There are also gross of fees/net of fees comparability issues in play.*

less common in the space. Many managers often have shorter track records, and it may take time to get familiar with newer property types. However, taking on these challenges could be worthwhile, given the return potential outside of the traditional core sectors.

Conclusions

The current economic crisis could be setting the stage for higher inflation over the next cycle. Simultaneously, it has brought several forces that are reshaping the real estate investment landscape into focus. This is an environment where allocators could be rewarded for selectively adding private real estate exposure.

Right now, we believe allocators would be well served by focusing on industrial and multifamily property types within core real estate. We're also excited about non-core opportunities. Finally, while this is more challenging to implement, we're staying mindful of opportunities outside of gateway cities.

As liquidity improves across the private real estate universe, we will look to help clients act on these themes. In some cases, this could involve taking a core-satellite approach, allocating to a mix of core and non-core funds to realize desired property type tilts. We're looking forward to helping clients capitalize on these trends, while staying mindful of illiquidity and risk tolerance constraints.

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