Real Estate Investments: The New Reality

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Session Objectives

• Define where we are in the real estate cycle
  “How did we get here?”

• Outline the forces influencing various sectors
  “Where are we going?”

• Describe the role of real estate equity and debt in a pension portfolio and different ways to access
  “What do we do about it in our portfolios?”
There is no shortage of headlines to make sense of...

**Bloomberg.com**

**Even a Recession Might Not Tame Inflation**

There are a lot of moving parts to the economy, and as the last three years have demonstrated, things don't always work as you expect.

2 days ago

**CNN**

**What OPEC's surprise oil cut means for gas prices**

OPEC and its allies’ surprise move to slash oil production will soon be felt at US gas pumps.

1 day ago

**Reuters**

**Fed sees credit drawdown looming, shifts towards pause on rate hikes**

Federal Reserve Chair Jerome Powell said banking industry stress could trigger a credit crunch with "significant" implications for the US...

2 weeks ago
...particularly as it relates to your portfolio.

**Macroeconomy**
- Strength of GDP growth = strong correlation to CRE
- Length of cycle impacts asset strategies
- Trajectory influences policy

**Geopolitics**
- Can drive equity markets lower
- Increase flows into safe-haven assets (like real estate)
- Knock-on effect to inflation

**Capital Markets**
- Influences relative attractiveness of asset classes
- Impacts borrowing/leverage costs
- Can influence strength of GDP backdrop

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**Bloomberg.com**

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Federal Reserve Chair Jerome Powell said banking industry stress could trigger a credit crunch with “significant” implications for the US...

2 weeks ago
We seem to be teetering on the brink of recession...

**Source:** American Realty Advisors
...though there are strong cases to be made both for and against a possible downturn.

Source: American Realty Advisors based on data from Macrobond as of April 2023
Each sector has unique drivers whose strength is derived from the broader economy

Demand stems from these macro forces...

Population Growth  Income Growth  Job Growth  GDP Growth

...with additional drivers influencing different sectors.

Industrial production  Trade  Retail sales  Inventory turnover  E-commerce
Household formation  Rent v. own decisions  Interest rates  Home prices
Corporate profits  Business confidence  Space density  Work-from-home
Retail sales  Savings rate  Consumer spending  E-commerce

Source: American Realty Advisors based on data from Green Street Advisors and Oxford Economics as of April 2023
The pace of growth of these drivers creates differences in sector profiles and positioning...

- **Early-Cycle**
  - Market Rent Recovery
  - Declining Vacancy
  - No New Construction
  - Demand For Space Increasing

- **Mid-Cycle**
  - Declining Vacancy
  - New Construction Increases
  - Rents Rising
  - Demand For Space Increasing

- **Late-Cycle**
  - Excess Supply
  - Increasing Vacancy
  - New Construction Continues
  - Rents Flattening

- **Recession**
  - Rents Falling
  - Construction Slows
  - Too Much Supply
  - Demand Falls

Source: American Realty Advisors
...but there are mega change forces that are poised to shake things up.

**Growth**
Growth keeps us on a predictable path.

**Change**
Changes creates disruption and opens opportunities for something new.

**ARA Identified Change Agents**

<table>
<thead>
<tr>
<th>Sociodemographic</th>
<th>Technology</th>
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<tbody>
<tr>
<td>Aging Population</td>
<td>E-Commerce</td>
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<tr>
<td>Labor Force Shift</td>
<td>Work from Home</td>
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<tr>
<td>Income Inequality</td>
<td>Big Data / 5G / AI</td>
</tr>
<tr>
<td>Migration / Immigration</td>
<td>Infrastructure</td>
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</table>

Source: American Realty Advisors
Industrial: Is There More Run Left in This Bull?
Pandemic Shone a Light on the Risks of “Just-in-Time” Supply Chains...

Retailer Inventory-to-Sale Ratio, 1992 - 2023

Source: American Realty Advisors based on data from St. Louis FRED as of April 2023
...Igniting a Rush of Demand for Warehouse Space to Store Goods.

Source: American Realty Advisors based on data from CBRE-EA as of April 2023
E-Commerce Got an Extra ‘Pop’ From Stay-at-Home (But Has Since Returned to Trend)

Source: American Realty Advisors based on data from St. Louis FRED as of April 2023

Total Retail Sales and % E-Commerce, Q4 1999 – Q4 2022

Source: American Realty Advisors based on data from St. Louis FRED as of April 2023
Industrial Drivers: Return to Normal

Inventories...went from too little to enough (especially relative to sales).

E-commerce...still strong, but people have got their fill of stuff – now they want services!

Manufacturing, imports slowing as companies try to sell off the inventory they have first.
Residential: Heating Up or Cooling Down?
Single-Family Housing Starts Never Fully Recovered after the GFC...

Source: American Realty Advisors based on data from Macrobond and Oxford Economics as of March 2023
…But it Wasn’t Until 2020 When Home Price Growth Really Broke From Trend.

Average Home Price Change, 2010 - 2022

Source: American Realty Advisors based on data from the Federal Housing Finance Agency as of March 2023
So, What Gives? For Starters, We Have Millennials Entering “Major Milestone” Life Stage.

Source: American Realty Advisors based on data from Green Street Advisors as of April 2023. f=forecast.
Normally This Would Mark Transition to Owning, But First Homes Are Out of Reach.

Bottom-Tier Single-Family Home Prices and Median Household Incomes, 2000 – 2023 (January 2000 = 100)

Source: American Realty Advisors based on data from Zillow and John Burns Real Estate Consulting as of April 2023
Instead, They Continue to Rent – Apartments, or, Increasingly, Single-Family Homes.

National Apartment and Single-Family Home Rent Growth, 2010 – 2022 (%)

Source: American Realty Advisors based on data from CBRE-EA and John Burns Real Estate Consulting as of April 2023
Despite Normally Being a Headwind to Home Values, Higher Interest Rates Aren’t Helping...

Source: American Realty Advisors based on data from Realtor.com as of April 2023
...Because Higher Interest Rates are Just Pricing More Would-Be Buyers Out for Longer.

Source: American Realty Advisors based on data from John Burns Real Estate Consulting as of April 2023. Figures on left reflect a $250,000 home with 6% down payment, customary of first-time buyers and assumes PMI and homeowners' insurance costs; calculations do not include monthly taxes, which vary by location.

### Number of Households Priced Out of a Mortgage by Price Point and Mortgage Rate

<table>
<thead>
<tr>
<th>Mortgage Rate</th>
<th>Monthly Mortgage + Insurance on $250K Home</th>
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<tbody>
<tr>
<td>2.0%</td>
<td>$1,114</td>
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<tr>
<td>3.0%</td>
<td>$1,237</td>
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<tr>
<td>4.0%</td>
<td>$1,368</td>
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<tr>
<td>5.0%</td>
<td>$1,507</td>
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<tr>
<td>6.0%</td>
<td>$1,855</td>
</tr>
<tr>
<td>7.0%</td>
<td>$1,809</td>
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</table>

30YR fixed rate

June 2021: 2.96%

-38% increase in ownership cost just from interest rate increase.

30YR fixed rate

March 2023: 6.32%

Source: American Realty Advisors based on data from John Burns Real Estate Consulting as of April 2023. Figures on left reflect a $250,000 home with 6% down payment, customary of first-time buyers and assumes PMI and homeowners' insurance costs; calculations do not include monthly taxes, which vary by location.
Residential Drivers: [Perhaps Discouragingly] Intact

Fewer young renters, more “geriatric Millennial” renters.

Less for-sale housing = more expensive for-sale housing.

Current single-family and multifamily starts declining, suggests little relief on the horizon.
Office: A Fundamental Question

• We asked ChatGPT
  “Given changes resulting from work from home, what is the future of the office real estate sector?”

• The answer was... inconclusive.
Office Job Growth Came Roaring Back as Strong Corporate Profits Spurred Increasing Hiring...

Source: American Realty Advisors based on data from CBRE-EA as of April 2023. f=forecast.
...But As We Know, That Has Not Translated To Demand for Office Space.

Year-over-Year Growth in Office-Using Employment and Net Office Absorption, 1991 – 2027F

Source: American Realty Advisors based on data from CBRE-EA as of April 2023. f=forecast.
The Relationship Between Office-Using Job Growth & Office Demand Had Already Been Waning...

Job Growth and Office Demand Growth Relationship: 2002-2009, 2010-2019 and 2020-2027f

Source: American Realty Advisors based on data from Green Street Advisors as of April 2023. f=forecast.
...in Part Because of Efforts to Densify Offices Over the Last Decade.

1990
325 sf/worker

2000
300 sf/worker

2010
225 sf/worker

2020
196 sf/worker

Source: American Realty Advisors based on data from JLL and Axios as of 2021
All This is Creating a Lot of Headline Weakness in Sector, With Vacancy Above GFC Peaks...

Source: American Realty Advisors based on data from CBRE-EA as of March 2023
...Though It’s Not Doom and Gloom Everywhere.

Market Vacancy Relative to Long-Term Average

- Current Vacancy < LTA
- Current Vacancy Within 100 bps of LTA
- Current Vacancy > 100 bps above LTA

Proportionate Share of Hardest-Hit Buildings by Size

- 100K to 300K
- 300K to 500K
- 500K to 1M
- > 1M

Small buildings account for disproportionate amount of vacant space added

Source: American Realty Advisors based on data from CBRE-EA and CBRE as of April 2023
Office Drivers: Long Road Ahead

Relationship between jobs and demand weakening.

Hybrid doesn’t necessarily mean less space is needed, but type of space will matter more.

Business confidence and corporate profits challenged in weaker economy.
Retail: What Happened to the “Apocalypse”? 

![Image of abandoned shopping mall](image1.jpg)

![Image of busy downtown street](image2.jpg)
Why Wasn’t the Pandemic Worse for the Retail Sector?

Number of Announced Retail Bankruptcies in the U.S., 2010 – 2023 YTD

Source: American Realty Advisors based on data from Statista and CBInsights as of April 2023. YTD 2023 data reflects announced major brand bankruptcies through April.
It Helps That There’s Been Very Little New Development.

Neighborhood and Community Center Construction SF, % of Existing Inventory, 2000 – 2022

Source: American Realty Advisors based on data from CBRE-EA as of April 2023
Retail Drivers: It’s All About the Consumer
What Role Can Real Estate Equity Serve In Your Portfolio?
A Smorgasbord of Pension Plan Benefits from Commercial Real Estate

**Returns**
Combination of steady income (like bonds) and market appreciation potential (like stock)

**Low Volatility**
Compared to other asset classes can lower risk

**Cash Flow**
Private real estate assets are replacing bonds as source of cash for benefits and other plan expenses

**Inflation Hedge**
Commodity prices influence replacement costs

**Diversification**
Low correlation to other asset classes, which can lower risk

Source: American Realty Advisors. There is no guarantee that any investment will be able to deliver such returns, capital preservation, or growth, as many factors such as changes in market conditions, interest rates, and responses to other economic, political or financial developments may influence returns and capital preservation. Please refer to the disclosures at the end of this presentation.
### Different Ways to Access

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>DEBT</th>
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<tr>
<td><strong>PRIVATE</strong></td>
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<tr>
<td>• Direct Investment in Equity Real Estate (Funds/Separate Accounts)</td>
<td>• Direct Investment in Real Estate Mortgages Origination of Real Estate Debt (Funds/Separate Accounts)</td>
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<tr>
<td><strong>PUBLIC</strong></td>
<td><strong>PUBLIC</strong></td>
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<tr>
<td>• Real Estate Operating Companies (REOC)/Real Estate Investment Trust (REITs)</td>
<td>• Traded Debt Funds</td>
</tr>
<tr>
<td></td>
<td>• Publicly Traded Mortgage-Backed Securities (CMBS)</td>
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Source: American Realty Advisors
Private Equity Real Estate: Bond-Like Income Resiliency with Equity-Like Appreciation Upside...

Source: American Realty Advisors based on data from NCREIF as of April 2023. Data reflects unlevered property-level returns, gross of fees. Past performance is not a guarantee of future results. Please see disclosures at the end of this presentation.
...With Compelling Downside Protection...

<table>
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<th>Average of Negative-Year Returns, 1978 – 2022</th>
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<tr>
<td>Equities</td>
</tr>
<tr>
<td>-14%</td>
</tr>
<tr>
<td>-12%</td>
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<td>-10%</td>
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<td>-8%</td>
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<th>Maximum Negative-Year Returns, 1978 – 2022</th>
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<tr>
<td>Public Real Estate</td>
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<tr>
<td>-14%</td>
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Note: Equities are represented by the S&P 500. Public real estate is represented by the FTSE Nareit All-Equity REITs Index. Private real estate is represented by the NCREIF Property Index. Bonds are represented by the U.S. 10-Year Bond. Source: American Realty Advisors based on data from NCREIF, NYU Stern School of Business and Macrobond as of April 2023. Data reflects returns, gross of any fees. Past performance is not a guarantee of future results. Please also see disclosures at the end of this presentation.
...and Higher Propensity for Strong Returns.

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Key Takeaways

• Beyond being influenced by the macroeconomy, each sector has its own unique drivers and cycles.

• Sociodemographic and technological changes are creating structural shifts in occupier demand (risk and opportunity).

• Sector selection was enough to distinguish manager winners/losers for many years; now outperformance comes down much more to individual asset selection.

• Real estate’s advantages:
  • Income
  • Downside protection
  • Diversification
  • Inflation protection

• Portfolios and strategies are not created equal – determining which vehicle best meets your fund’s needs depends on:
  • Return and liquidity requirements
  • Execution strategy/risk tolerance
  • Sector/market/asset composition

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information has not been independently verified by BGO.
An Expanding Universe of Opportunities

The range of opportunities available today is reflective of the evolution of real estate debt as a mainstream strategy.

- **Core Lending**: Typically long-term, fixed rate loans secured by stabilized assets.
- **Core Plus Lending**: Fixed or floating rate loans secured by assets experiencing partial cash flow disruption and undergoing light transition.
- **Value-Add Lending**: Floating rate loans secured by assets undergoing more significant transition and disruption in cash flow.
- **Tactical/Opportunistic**: Loans secured by assets with little to no cash flow and undergoing development or reconstruction. May also include distressed situations.

Risk/Return Spectrum for Performing Loans
Demand for Alternative Lenders is Accelerating, Driven by Bank Retrenchment...

Community and regional banks hold more than $2 trillion of CRE debt\(^1\) and CRE bank portfolios are expected to come under heightened scrutiny amidst bank failures.

**Commercial Real Estate Loans As A Share of Total Assets (%)\(^2\)**

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**Composition of Bank Lending Volume\(^2\)**

- Acquisitions 27%
- Construction Loans 37%
- Refinancing 36%

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1. Source: Trepp
2. Source: CBRE

Large banks are defined as the top 25 domestically-chartered banks ranked by domestic assets. Large bank assets represent two-thirds of all bank assets.
...And a Steep Decline in CMBS Issuance

New issuance has slowed significantly due to continued macro uncertainty and the challenges of originating loans at higher coupons, paired with realized or anticipated lower valuations.

1. Source: CRE Finance Council as of February 2023
Nearly $900 billion of Commercial Loan Maturities in 2023 and 2024

CMBS dominates the first wave of commercial real estate loan maturities in 2023; bank lenders comprise an increasing share in the years ahead.

Volume of maturing commercial property loans by lender type

1. Source: MSCI as of March 30, 2023
2. 2023 CMBS maturities sourced from Trepp as of March 17, 2023
How it Started and How it’s Going...

Loan metrics have shifted meaningfully from February 2022 to March 2023.

Example: Value-Add Senior/Whole Loan

1. The above deal return is a gross figure and does not reflect advisory fees and other expenses that the fund would pay, which could be substantial and would decrease the return. The target returns are reliant upon assumptions and projections derived by the fund and as such are hypothetical and not a guarantee of future performance. Actual results may differ materially.
Considerations for Constructing a Real Estate Debt Portfolio

- Strong alignment of interest with the borrower
- Focus on loan structure and lender protections
- Diversified exposure to property types and value-add business plans
- Institutional-quality borrowers with strong balance sheets and demonstrated expertise
- Value creation and improved risk position at the end of the loan

Representative Value-Add Lending Portfolio

- 1/3 Acquisition Loans
- 1/3 Refinancing / Opportunistic Recapitalizations
- 1/3 Construction