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INVESTING IN PRIVATE MARKETS NORTH AMERICA 2021

Finding opportunities in the face of economic headwinds and inflationary pressures

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MetLife Investment Management

2.1 INTERVIEW

Real estate strategies show resilience in the current market

Interviewer

David Grana,
Head of North America Media, Clear Path Analysis

Interviewee

Adam Ruggiero,
Managing Director, MetLife Investment Management

SUMMARY

- *Real estate strategies are commonly divided into core, core-plus, value-add, and opportunistic*
- *Operating risk and leverage are the primary differentiating factors between strategies*
- *The rise of e-commerce and its acceleration during the pandemic has boosted desirability of industrial real estate*
- *Real estate assets have historically acted as an effective inflation hedge*
- *Broad price compression is unlikely in the near term, but value declines in some property types may continue*

David Grana: Can you walk us through the different types of real estate strategies? What differentiates core, core-plus, value-add, and opportunistic?

Adam Ruggiero: Generally speaking, there are four types of real estate strategies, each separated largely by their respective level of operating risk. The lower risk strategies, core and core-plus, are often lumped together in the "core" allocation of many portfolios, while value-add and opportunistic strategies are typically classified as "non-core." The appropriate designation of core-plus within these two buckets remains a topic of debate and views often differ between investors.

Core strategies exhibit the lowest operating risk and involve the acquisition of assets that are at or near-full occupancy. The primary goal of these strategies is to generate steady income with a potential for income growth through either contractual rent increases or the signing of new leases at higher rates. Appreciation is a lesser focus of these strategies and typically tracks with inflation over the long term.

Core-plus strategies focus on assets with moderately higher operating risk. A classic example would be an asset that is 70% or 80% occupied, acquired with the objective of leasing up the remaining space. Core-plus acquisitions may require physical improvements, a change in leasing strategy, or both. Common improvements include new elevators and modest upgrades to building systems, renovations to lobbies or other interior spaces, and improvements to grounds or building amenities. These strategies typically generate a mix of income and appreciation, with appreciation typically comprising greater than 50% of total returns.

Value-add and opportunistic strategies involve higher levels of operating risk than core-plus and typically drive their returns almost entirely through appreciation. Value-add properties typically have significantly higher vacancy and may need much higher levels of capital investment. There may also be a need or opportunity to reposition assets by changing their use, such as transforming an aging office building into modern apartments.

Opportunistic and value-add strategies are relatively similar, often involving similarly high levels of operating risk, so it can be difficult to determine where one ends and the other begins. Ground up development, as opposed to the acquisition of an existing asset, is often classified as opportunistic, but it may be more accurate to view it as an acquisition strategy than an investment strategy unto itself.

One of the easiest ways to differentiate between value-add and opportunistic is the amount of leverage employed. In fact, leverage can often be used to identify a given strategy even in the absence of other information. Historically, the amount of leverage employed

> RESEARCH SUGGESTS THAT THE MOST ATTRACTIVE HIGHER OPERATING RISK STRATEGY IS GROUND UP DEVELOPMENT RATHER THAN VALUE-ADD

and the amount of operating risk taken in a given strategy are highly correlated. A core strategy typically has low operating risk and minimal leverage, between 0-30%. Core-plus uses 30-50% leverage and may take moderate operating risk, while value add strategies typically use 50-65% leverage and opportunistic north of 65%, both while taking on significantly greater operating risk.

David: How long is the timeline for cash flow and return on investment for each of the different strategies?

Adam: It is probably helpful to first explain that commercial real estate ROI is comprised of both income and appreciation, and that regular appraisals allow investors to recognize appreciation without requiring the sale of an asset.

Appreciation is driven primarily by income growth, but can also be driven by yield compression. Cap rate, which is net operating income divided by value, is the standard yield measure used for commercial real estate in the US. The market has experienced compressing cap rates for much of the last 25 years - a trend that many thought would be coming to an end in the wake of the COVID-19 pandemic. Depending on the property type, however, the reality has been very different. While retail and office cap rates have widened in certain segments and markets, cap rate compression has continued in industrial and multifamily assets in most markets.

Returning to timing, core strategies typically offer the most stable returns and typically achieve the majority of those returns from acquisition since they are heavily driven by in-place income. Core-plus strategies also generate income from the point of acquisition, but will not achieve their target appreciation returns until improvements are complete and vacant space is leased. The same progression is true for value-add and opportunistic strategies, but timelines are typically elongated relative to the amount of operating risk being taken. Income returns are also likely to be reduced relative to the rate of leverage employed due to higher financing costs.

David: You mentioned earlier that those are traditional definitions for the major strategies. Are there any alternative approaches?

Adam: Yes, absolutely, developing alternatives has been a major focus of ours, particularly as it relates to the peculiar correlation between operating risk and leverage that I mentioned earlier. There is no practical reason why low operating risk should be paired with low leverage and high operating risk should be paired with high leverage, but it has long been the market convention. Higher leverage can result in higher returns, but when paired with higher operating risk, the result is typically lower risk-adjusted returns over time. The primary reason why is the historical volatility of income and appreciation returns and their relative contribution to total returns.

Historically, we have found that roughly 80-90% of unlevered real estate returns come from income, but 80-90% of their volatility comes from appreciation. Therefore, we believe that if investors want to reduce volatility and improve risk-adjusted performance, they should favor income over appreciation in the composition of returns. It is important to remember, however, that we do not live in a purely risk-adjusted world. Investors have absolute return targets that they need to hit, such that a strategy with historically attractive risk-adjusted returns, like core, may fall short of their overall return objectives.

As we attempted to develop alternative strategies that could boost absolute performance while maintaining strong risk-adjusted returns, we leaned on the work of the academic community, our own research, and our decades of experience in the market. The result is an approach that attempts to split the difference between traditional approaches to operating risk and leverage. We believe that a portfolio comprised largely of core assets that employs moderate amounts of leverage in the range of 40 – 50% has the potential to generate stable income while offering the potential to enhance the lower levels of appreciation typical of core strategies.

If an investor is seeking to boost returns further than a typical range for leveraged core, our research suggests that the most attractive higher operating risk strategy is ground-up development rather than in which the investor enters the transaction. For example, in the pre-development phase, following the identification of a land site, there are many potential unknowns, such as the speed of municipal approvals, potential environmental concerns, design decisions, and construction budgeting, among others. All of these efforts require upfront costs that may or may not be recoverable, depending on if the project moves forward. Developing a new real asset can be a long and laborious process, so we feel a long track record of experience in direct development activity or working closely with local operating partners should be viewed as a must by any investor considering the strategy.

> “There is one property type where COVID has had almost no negative impact, and in many cases, an entirely positive one, industrial”

value-add. There are two types of development strategies: build-to-sell and build-to-core. In build-to-sell, assets are constructed, leased, and sold, while in build-to-core, they are held for the long-term following lease up. Newly constructed assets are typically highly competitive in the leasing market, boasting the most modern systems and attractive, flexible designs able to accommodate modern floor plans. Value-add projects, while potentially well executed, may find their competitiveness limited by an older building's physical structure. Older office assets, for example, may include interior columns that prevent an open layout, or lack large floor-to-ceiling window lines that prevent light from reaching interior spaces. Building systems and architectural elements may also impede efforts to reduce carbon emissions and achieve maximum energy efficiency.

David: In addition to different investment strategies in each profile, you mentioned there are also different acquisition strategies. Can you go into more detail on the differences between existing acquisitions vs. development?

Adam: Existing assets are largely known quantities to those with a local presence and a strong understanding of the local market. Our approach to real estate investing has always relied heavily on local knowledge obtained by regional offices located throughout the country. Our experience has shown us that having acquisition officers and asset managers located in or near the markets where we operate can be a tremendous advantage in what remains a largely private market where information asymmetry can be substantial. An outside buyer may be able to accurately assess a property's current income, but without boots on the ground, it can be a much greater challenge to understand a market's leasing dynamics and the needs of its major tenants. A local presence also supports due diligence efforts during which buyers seek to discover any potential negative aspects of an investment that have not been disclosed by the seller, such as any open legal, environmental, or structural issues.

Development projects typically include quite a few more unknowns, which may be dictated by the phase of the development process

Experienced managers and operators may be more skilled in shortening the list of potential unknowns and reducing operating risk. We believe one of the most attractive potential development opportunities is what we call a build-to-suit, in which a tenant approaches a developer to construct a building specifically for their use. By removing leasing risk from the equation, the overall risk profile of a development project can be significantly reduced. Large tenants are looking for quality and surety of delivery, so only the more experienced operators and their partners are likely to have access to these transactions.

David: As you look at the market today, where do each of the major property sectors stand? How were they impacted by COVID and what do they look like in a post-COVID world?

Adam: It has had a substantial short-term impact on multiple property types, but we think the long-term impacts vary considerably and are being misperceived by many, which should create quite a few opportunities over the next few years.

There is one property type where COVID has had almost no negative impact, and in many cases, an entirely positive one: industrial, which consists almost entirely of distribution and warehouse space. Industrial demand has been rising throughout the last decade, driven by rising e-commerce spending and a shortening of delivery windows from multiple weeks to one or two days, and in some cases, within hours. Prior to the rise of e-commerce, the sector was dominated by trade-driven port facilities, but today the industrial market offers opportunities across the United States in any market where population growth is healthy.

The other three major property types, office, apartments, and retail, have all experienced some measure of negative impact, but it is important to recognize that very few trends were actually created by the pandemic. It was instead a dramatic accelerant to trends already underway. Although retail real estate has been heavily impacted by COVID-related closures, many segments of the sector were already

> "HISTORICALLY, REAL ESTATE HAS BEEN AN EFFECTIVE HEDGE AGAINST INFLATION, RUNNING ROUGHLY IN LINE WITH IT"

struggling to compete with e-commerce retailers. The greatest weakness was among enclosed malls, particularly B and C malls in areas of the country that are struggling economically. The A malls, where population growth remains positive and incomes remain high, were actually doing fairly well pre-pandemic and have already started to recover. Retail in the lifestyle segment, such as entertainment facilities, movie theatres, dining, and services, while taking it on the chin due to closures, are also better positioned to recover post-pandemic because their offerings cannot be replicated online. As we look towards the future, we continue to view centers in the lifestyle segment as attractive, particularly if paired with a large grocery anchor to provide a firm base of steady income and drive traffic to the center.

In the same way that industrial and retail are very closely related, so too are office and multifamily apartments. The multifamily sector has had a very strong run over the past decade, enjoying a tremendous amount of demand created by the millennial generation. Misconceptions about millennials, specifically that they are a forever urban generation, have come to the forefront in the wake of the pandemic. With the exception of a small handful of markets, the percentage of young people living in cities hasn't been any higher than past generations, despite what the headlines might have suggested. In fact, Millennials were clear about their eventual intention to own a home and today, many are making that a reality. Much of the market, however, was not expecting any decline in multifamily demand driven by Millennials and has been caught off guard by the events of the last year. In my opinion, they shouldn't have been since the demographic data was pretty clear. The surprise was that it occurred during a single year instead of over the next three. Ultimately, we feel the outlook for multifamily is still relatively bright, but 2021 is likely to be bumpy in some major urban markets while supply and demand rebalance.

The office sector is perhaps the only place where you can argue that the pandemic has created a new trend, though there is room for debate even there. Working from home is hardly new, but our ability to do so has increased significantly in recent years, as has the preference to do so. The question now is whether we are moving to a full work from home environment. That tends to be the prevailing narrative today, but like the forever urban Millennial, the evidence is scant. Even setting aside the obvious difficulties of working from home over the long term, such as onboarding new staff, efficient communication, and decreased collaboration, we know of tenants that have tried the concept before and have been unsuccessful. That includes exactly the type of tenants you might think would know exactly how to make it work. It is no coincidence that many major tech firms attempted to move to work from home in the early part of the 2010s and then built large campuses in the latter half.

Our view is that the relationship between working from home and in the office will reach a place of balance, perhaps with three days in the office and two at home. The ultimate impact on office demand may be small since this type of schedule does not necessarily mean a reduction in space unless tenants move to hoteling or hot desk concepts that workers typically dread. For the apartment sector, the implications could be greater, not just between markets, but within them. A 60 or 90-minute commute is much easier to bear three days a week than it is five days a week. This suggests to us that CBD office may remain healthy in a post pandemic world, supported by workers commuting in from satellite cities and dense suburbs.

David: In addition to the post-COVID recovery there are other macro forces at play that have gained new prominence, including the potential for rising inflation. What role do you think real estate plays in a rising inflation environment?

Adam: Inflation tends to be a factor that excites you as a real estate investor. Historically, real estate has been an effective hedge against inflation, running roughly in line with it. This occurs because real estate income is driven by leases that periodically roll to market rates which reflect increases in the cost of labor and materials. For a borrower of long-term leverage, this can be a particularly attractive scenario, because if income is rising over time, so too is the spread on a fixed-rate loan.

David: Are there any other types of macro factors that you feel might be worth noting that might have an impact on real estate?

Adam: The shape of the capital markets is always worth touching on. Today, most of the capital in real estate is flowing towards higher risk strategies. The logic there is that if you do want to take operating risk, it is generally wiser to do so at the beginning of a cycle rather than at the end. It is a timing-based decision that is governed by the likelihood of achieving appreciation and disposing of an asset according to the schedule called for by closed-end fund vehicles. For investors more concerned with long-term risk adjusted returns, however, we think core and core-plus strategies should remain attractive today. Higher risk strategies like value-add and opportunistic may also face some challenges that make their typical return hurdles difficult to meet.

Post-GFC, there were substantial declines in value across property types, with the office sector taking the biggest hit, with declines of around 35-40%. Today, however, value declines have not been nearly as substantial, nor have we witnessed a persistent decline in demand. Much of this can be attributed to the tremendous amount of government stimulus that has supported both individuals and corporations, but as the economy begins to reopen, normal leasing activity is accelerating as well. As a result, rent collections have remained close to normal levels, preventing the level of distress we saw following the GFC. The result is that the bargain prices and large amount of upgradable space that value add and opportunistic investors relied on following the GFC are likely to be less prevalent today. With more capital chasing fewer opportunities, the likely result is lower returns despite the comparable risk.

David: Is there a potential that we could see price compression down the line?

Adam: In the near term, we don't see indications of that for the majority of property types. In certain segments of the retail sector, such as B and C malls, it appears highly likely. We may also see declines for downtown office properties and urban multifamily in a handful of markets as prevailing misconceptions about long-term trends are reconciled with the likely reality, but those declines appear likely to be relatively modest, perhaps no greater than 5%, depending on the market.

It is quite unusual for real estate values to decline during a period of economic expansion. We don't know how long this new economic expansion is going to last of course, but if prior economic expansions are any indication, we would expect quite a bit of room to run. For the last thirty years, economic expansions have been getting progressively longer, which means we could be entering a period of rising real estate values for the next decade or more.

David: Thank you for sharing your thoughts on this topic.

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