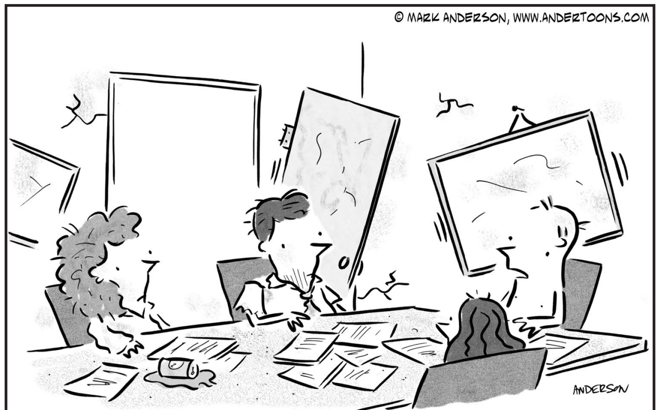
March 2017

Making Real Estate Investing Great Again: Hodes Weill's 10 Observations for 2017



"We've got the disruptive part down, now we just need to innovate."

In case we forgot, 2016 provided many indications that on any given day, we are going to be humbled by our inability to predict events. Through the daily barrage of unexpected headlines, we were reminded that history (and historic change) is hard to predict and usually only obvious after the fact. Despite advances in technology, transparency and fact-gathering, we shouldn't become complacent that the past is prologue or that we can anticipate future behavior based on old patterns.

In the not-too-distant past, if someone used the qualifier "disruptive", they were generally talking about how new technologies were impacting industry – implying change, and the kind of change that typically takes cost and inefficiency out of a system. 2016 was the year when the power of disruption was refocused on political orders worldwide. Disruption has altered entire political establishments in countries around the world, most obviously the US, the UK and the dominant countries across Europe. As we write, we await the outcomes of further elections in the Netherlands, France and Germany, in order to assess what is left standing of the old Western political status quo.

This disruption would normally lead us to expect risk premiums to rise. It seems that this fundamental rule of investing has also been disrupted. To be fair, that was the immediate post-Brexit impact on pricing of London assets, but prices quickly returned to their pre-Brexit levels as most investors saw this as a buying opportunity. The twin catalysts of the ninth year of low interest rates and the ongoing need for current yield have substantially muted this recalibration of risk. Real estate prices essentially plateaued on a global basis last year. So, despite clear signals of added external risks, institutional investors continued to price assets at reasonably high levels, taking some comfort that fundamentals are generally positive. Investors are demonstrating increasing caution, but have remained consistently in the market, to this point.

Despite the ever-present flock of black swans circling overhead, and little clarity about the consistency and stability of the world's largest superpowers, the traditional characteristics of real estate assets have been reinforced during 2016. Real estate's predictable current yield and the reasonable expectation of capital preservation (and over time, some appreciation), have all continued to be borne out. Institutional memories of the Global Financial Crisis ("GFC") remain vivid, and leverage and development financing levels have been moderate for the most part (other than a truly startling increase in construction in downtown LA!).

With other alternative asset classes also experiencing volatility and excessive liquidity, real estate has proven to be a surprisingly durable investment option and has continued to absorb substantial flows of capital from investors all over the world. Thus, we anticipate that 2017 will look much like the past year, with investors proceeding albeit with caution.

And so, knowing that our radar has been severely tested during the past 12 months, we once again (bravely) present our 2017 observations and expectations for the global real estate private equity market.

1. The Times, They Are A-Changin'

Much has been written about the proliferation of technology and how it is forever changing the real estate landscape for future generations. As is typical with technology, the pace and implementation of advancement often exceeds our wildest predictions. What was talked about yesterday as theory, may already be here today as practice. Many key advancements have already positively impacted commercial real estate. Investors who closely track technology and most quickly adapt to it, will be rewarded with an additional source of alpha. While we'll be surprised yet again by technology not yet on our radar, those in view are worth tracking in 2017:

"WHAT DO YOU MEAN, YOU WANT A COFFEE BREAK ?!"

- ***The Sharing Economy:*** WeWork and Airbnb have firmly solidified their place in our economy and have dramatically changed how landlords can re-imagine their properties. Both companies have provided landlords the ability to generate revenue from previously underutilized space, which has increased asset values. Over time, we anticipate that tenants may demand that property investors and owners think more carefully about the appropriate size, usage, layout and amenities of their buildings, whether for development or refurbishment strategies. However, many new economy tenants have weak credit, and landlords will need to seriously evaluate the extent to which they want to spend capital to attract them.
- ***Property and Asset Management Efficiencies:*** Over the past several years, venture capital has funded companies focused on using new technologies to enhance the efficiency of real estate asset management. Consider the range: construction technology, leasing systems, hotel customer management (e.g., robot butlers and keyless rooms), vendor maintenance, green initiatives, parking services and capital spending efficiencies. Each new tool has the ability to reduce operating costs and drive revenue, boosting NOI. In today's environment, property owners need to be willing to spend the time and capital to implement these management innovations to remain competitive in a demanding market. Commercial real estate investors will have a greater ability to look across and through their portfolios with much greater speed and efficiency. As often happens, this transparency may trigger greater accountability and performance benchmarking, resulting in further consolidation to those who show best-in-class management skills.
- ***Autonomous Vehicles:*** The advancement of driverless vehicles has dominated headlines in recent years. While it will take some time and a revamping of infrastructure before they become ubiquitous, real estate investors are

beginning to consider how autonomous vehicles will affect their investments. Autonomous vehicles will essentially change everything, from commuting patterns to parking requirements, to potential weakening of "last mile" industrial corridors, just to name a few.

2. Give 'em Some Credit

Over the past several years, we have witnessed the proliferation of real estate credit managers aggregating large private funds. During the last four years alone, $85 billion has been raised across 172 credit funds globally.[1] The natural conclusion might be that borrower needs have been fulfilled with the shift from traditional to "shadow" lenders filling the void. This underestimates the scale of the ongoing capital markets requirement for real estate credit. The forecast demand for credit indicates that seasoned real estate credit platforms with wide sourcing capabilities will continue to see substantial borrower demand in the US and Europe.

Exhibit 1: Net Percent of Respondents Reporting Tightening Standards for CRE Loans

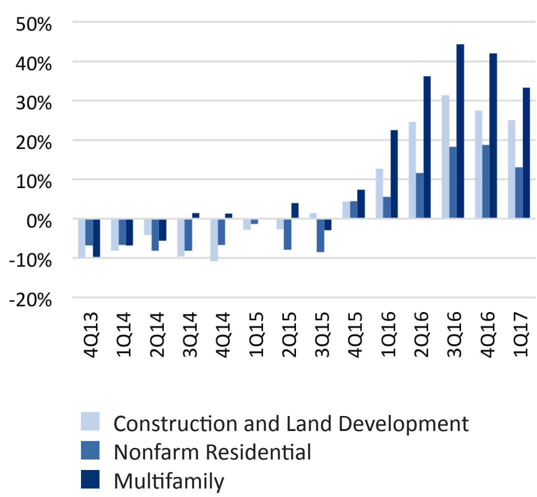


Exhibit 2: Lender Market Share

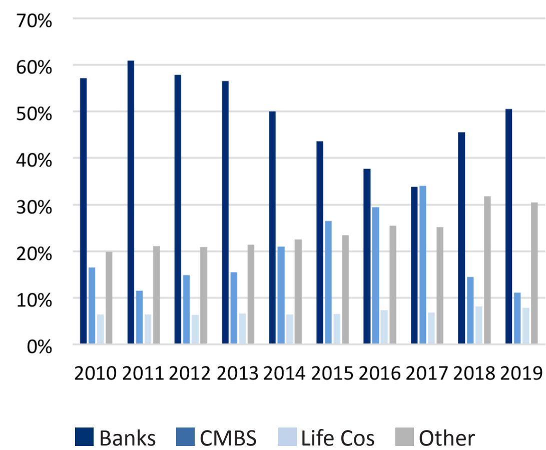


Exhibit 1 Source: Federal Reserve: 2017 Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2017
Exhibit 2 Source: Trepp, LLC, as of June 30, 2016. Includes projected figures through 2019

Naturally, this has shifted activity to the "shadow finance" space, driven primarily by private funds and some active mortgage REITs. As noted in Exhibit 2 above, from 2010 to 2016, banks have meaningfully decreased their market share from 57% to 38%. Similarly, while CMBS has seen a rebound since the GFC, its 30% market share in 2016 is projected to drop to just 11% by 2019. The result is that private lenders are filling a meaningful void, increasing their market share from 20% to 26% between 2010 and 2016. This is expected to increase to as much as one-third of the commercial lending activity by 2019. Remember the wall of debt? There are a lot more lenders trying to scale it!

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[1] Preqin

3. The Long March

Last November, the Chinese government ramped up measures to curtail capital outflows in a bid to stem currency depreciation and restrict the ability of institutions to park capital offshore in non-strategic investments. A raft of measures had already been in place for much of last year, but were only loosely implemented. The new steps have included tightening of restrictions on investments by size and type; delays in foreign exchange clearance, even for previously approved projects; and "guidance" to major institutions, particularly SOEs and insurance companies.

The restrictions have started to bite. We have seen deals cancelled, funding delays and what has been especially chilling to private fund managers, some instances of capital calls not being met. Even in cases where new investments are technically within the rules, institutional investors are reluctant to get too far ahead of the pack before the Communist Party National Congress this Fall. There will potentially be sweeping changes to leadership positions within the Party and the state-owned enterprises. In spite of this, a small number of deals are getting done, typically those having received approvals before the restrictions or where the buyers have access to funding that is already held offshore. Asset sellers and fund managers would nevertheless be wise to temper their expectations about attracting Chinese capital this year, especially if certainty of timing is critical. Some managers, whether warranted or not, say they are concerned that Chinese institutions may find it difficult to meet capital calls under earlier contractual commitments to funds and investments. The US-China political relationship also appears that it will be a little bumpy and could potentially also weigh heavily on funds flows between the two countries.

While Chinese outbound capital flows into global real estate investments did not start in any material respect until 2010, China has since come to represent one of the largest capital pools for global real estate. The same drivers that have fueled these outflows to-date remain intact: desire for dollar assets; diversification; limited domestic investment alternatives; and a desire to move capital beyond the government's purview. Furthermore, Chinese institutions, particularly insurance companies and SWFs, remain underinvested in real estate. Consequently, we expect Chinese capital to find its way back into global real estate investment opportunities later in the year as China resumes the Long March to establishing itself as one of the most potent forces in the global real estate capital markets.

4. European Opportunity – The Empire Strikes Back

Volatile currencies. Government elections and referendums. Unfamiliar regulatory and tax regimes. Brexit. All good reasons for concern when it comes to institutional investors allocating capital to investments in European real estate. While these considerations might have kept many institutions closer to home in recent years, the last 18 to 24 months have seen increased interest in Europe from North America and Asia. Despite the unexpected result of the Brexit vote sending short term shockwaves through the markets, and despite potential disruption in other upcoming elections, we see the appetite for Europe continuing, albeit with more caution. Indeed, 64% of investors from the Americas are considering investments in Continental Europe with 58% considering the UK. Interest is similarly strong out of APAC, with 70% and 75% of institutions considering investments in Continental Europe and the UK, respectively.[2]

In terms of strategies, substantial capital will continue to be committed to distressed investing. In addition, defensive, regulatory (i.e., tax efficient), and demographically driven opportunities in Europe have also been attracting global investors. For example, we have seen interest for residential strategies in Ireland, demographic strategies in the

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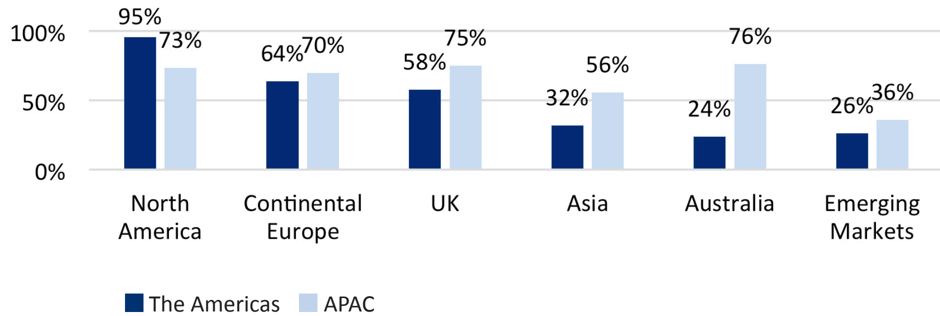
[2] Jones, D., & Weill, D. (2016). 2016 Institutional Real Estate Allocations Monitor. Ithaca, NY: Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP, October 2016.

Exhibit 3: Geographic Focus

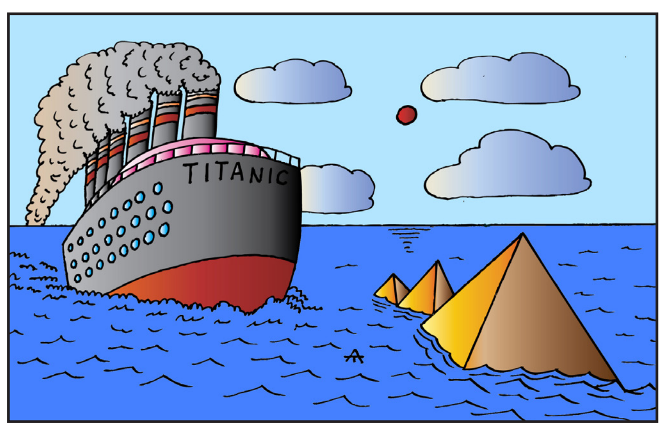


Source: Jones, D., & Weill, D. (2016). 2016 Institutional Real Estate Allocations Monitor. Ithaca, NY: Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP, October 2016

UK and Europe (e.g., student housing, healthcare opportunities), traditional value add and income oriented credit strategies.

In term of geographic focus, Germany is generating strong interest across property types from cautious investors seeking European exposure but on a more defensive basis. Germany's office markets are relatively undersupplied with prime space; its retail markets remain protected by strong zoning laws; it has a lower-than-European-average use of online retailing; and its logistics markets are the gateway to Central and Eastern Europe while also serving its 80+ million population. The real estate opportunity is further underpinned by the strongest economy in Europe driven by manufacturing and technology, and the exports these sectors create. In a market storm investors tend to head for safe havens. Despite whatever happens politically in Europe in 2017, Germany is generally viewed as the safest market for investors searching for exposure to the Continent.

5. The Rising Tide



Scientists reported that the Earth reached its highest temperature in 2016, the third year in a row that set a new record. In fact, of the 17 hottest years on record, 16 have occurred since 2000. Heat extremes were especially pervasive in the Arctic where last fall's temperatures were 20 to 30 degrees above normal and contributed to a precipitous drop in sea ice, and in turn rising sea levels. As we learned from recent "superstorms", there can be catastrophic damage to real estate and infrastructure from rising seas and storm driven flooding. That said, we do not see many real estate managers or institutional investors factoring these risks into their decision making. Developers continue to build in areas most vulnerable to climate change. The issue is especially acute in Florida, which has six of the ten urban centers most vulnerable to storm surges according to Core Logic, a real estate data firm. But Florida is not alone, as 40% of Americans live and work in coastal areas.

Whether it is nuisance flooding or the King tides in Miami, real estate property values are starting to be impacted. Some take comfort in the pace of sea levels rising, with the false hope that it won't affect them during the hold period. But this misses the point, as property values will likely decline "in the eyes of the next buyer" even before impairments in the utility of properties becomes apparent due to such factors as the inability to get flood insurance or even a mortgage.

The real estate and mortgage markets have been slow to confront climate change. Disclosure is partly to blame as there is a strong disincentive by local authorities to reveal data that could be damaging to a tax base. The burden of discovery falls to the buyer and it should clearly be a factor in the underwriting for coastal properties. Other industries including agriculture, oil and utilities have been forced to account for the impact of a warming planet, and it is high time more real estate investors do so as well.

6. Finding Your Niche

Both direct and fund investors continue to back "sharp shooters" – managers pursuing niche strategies, especially those that are demographically supported. Strategies with strong momentum that are attracting capital include:

- ***Street retail:*** Catering to millennials who demand retail experiences they cannot otherwise access through online shopping;
- ***Self-storage:*** Catering to baby boomers down-sizing and millennials not buying homes or living in smaller accommodations;
- ***Student housing:*** Which is having its moment on a global basis. Investors such as CPPIB, PSP, Goldman Sachs and GIC are making substantial allocations to the sector, and managers are paying attention. Greystar has committed to about £3bn in co-investments in the UK since 2013;
- ***Senior housing:*** Which should continue to benefit from the increasing number of baby boomers reaching retirement age; and
- ***Healthcare strategies:*** Which will benefit from both the same demographic trend as senior housing as well as the shift to freestanding urgent care centers and medical offices separate from hospital centers with efforts to reduce the total cost of healthcare.

In just the last 12 months, funds targeting niche strategies raised $4 billion, over a third of which was raised by first-time funds.[3] Blackstone, who is not a manager that typically makes niche plays, but rather an industry leader who makes long-term bets with conviction, recently announced its plans to enter new asset types, citing life-science real estate and last-mile logistics as near term targets. There will always be a home for successful broad-based strategies in investors' portfolios, but we expect that the demand for niche strategies will continue as investors seek cycle-resistant strategies and sector-specific managers with good track records and deep expertise.

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[3] Preqin

7. Experiential Retail Real Estate

Experiential retail should continue to be the wave of the future in the retail real estate asset class. While traditional retail tenants and their landlords remain under pressure from internet retailers with less need for brick-and-mortar locations, those that offer "internet-resistant" opportunities should continue to see high traffic from prospective customers, and hopefully, positive sales performance. Retail is now designed to cater to the broader lifestyle vs. shopping choices made by consumers, particularly for food, fitness, entertainment, convenience and networking. The buzzword seems to be "curate," as landlords try to ensure that the tenant mix is reflective of consumer and demographic preferences.

In New York, as in many other cities, this trend is readily visible with numerous high profile experiential stores having opened their doors in recent years. Among these, the five-story Nike Soho, which opened last November, has been positioned as a "personal sport experience". Nike hopes that the location's Nike+ Basketball, Running, and Soccer Trial Zones, Nike By NYC (an instant personalization studio for Nike products), and enhanced fitting rooms that offer an array of services like one-on-one appointments and fittings, will help customers "realize the promise of personalized performance."

Other retailers are finding that "click and collect" is their most profitable way of selling as they can stock items off site, efficiently ship in bulk to store locations, and then offer the customer a chance to see and try on/out the item. Turning their real estate into consumer fulfillment centers allows the retailer to improve their margins by avoiding "last mile" deliveries and reducing returned goods.

8. "Without Promotion, Something Terrible Happens…Nothing"

In a sign of the times, the curtain has come down on P.T. Barnum's Ringling Bros. and Barnum & Bailey Circus, which closed after 146 years of operations. P.T. Barnum was a showman who has been quoted extensively over several generations. Many are familiar with his most famous quote: "a sucker is born every minute". But another lesser-known quote is very relevant to today's fund management industry: "Without promotion, something terrible happens…nothing".

In today's low interest rate, and more importantly low return environment, many industry participants are beginning to rethink the construct of incentive fees – in particular, the level of preferred returns The "low pref, no catch up" structure favored by some investors may make more sense as return expectations moderate, especially for lower risk investment strategies. These structures are also potentially more appropriate for managers and institutional investors that are focused on increasing the duration of their investment portfolios. Chasing a 9% pref for 3 to 5 years may be appropriate, but the math simply does not work for a 7 to 10-year hold. We expect that both investors and managers will continue to revisit preferred returns and consider alternative fee constructs to better "promote" managers for delivering performance consistent with the objectives of their clients.

9. Home Sweet Home

Much of Western Europe is suffering from an on-going housing shortage that results from very limited additions to supply for many years, changing internal demographics, and immigration. Nearly every government in the region is implementing policies to encourage the private sector to develop suitable housing to help solve the problem. Each country has its own challenges. The UK has an expensive for-sale market, and an immature and undersupplied "private rented sector" (PRS). The Netherlands has a PRS sector that is very mature, well-supplied and partially regulated, while the for-sale market has only recently started to recover from the GFC. Add to this the fact that German home dwellers have started to buy rather than rent at a rate higher than historical averages plus the surge of immigration in the country, and you have a huge diversity of market conditions for investors, both from within the region or from outside, to consider.

Currently, if investors have the risk tolerance to develop for-sale or for-rent housing, most markets have strong demand plus government policies that encourage activity through "Help to Buy" mortgage deposits or tax-break schemes. We may be nearly a decade on from the sharp re-pricing that took place during the GFC, but many investors have concluded that defensive opportunities still exist for investors to take advantage of supply-demand imbalances that have been exacerbated by the extended pause in the housing development markets.

10. Are You In or Are You Out

The ODCE (US diversified open-ended core) fund universe has had a phenomenal run since the dark days of the GFC. The overall universe has expanded from approximately a dozen funds with about $80 billion of assets in 2009 to today, when this universe comprises 24 funds and over $200 billion of total capital. We have previously written about the growing, global embrace of open end (or perpetual) vehicles as an important tool for executing real estate portfolio strategies. 2016 may mark the year when the tide went back out.

The latest figures from NCREIF show that net flows into ODCE funds last year were the lowest annual total since 2009. This may reflect the growing concern that pricing in the US market may put many of these funds at risk. After all, core funds are not intended to generate mid-teens returns for multiple years, and without continued cap rate compression for core assets, NOI is unlikely to grow fast enough to support the recent levels of returns. In search of better returns, many of the larger funds have also pursued development and other value add strategies which increases the risk for a drag on returns if leasing (and capital) markets slow down as projects are coming on line. The ODCE funds used to look very similar, all generating returns within a relatively narrow band, but that is no longer the case with very different risk profiles among the peer group.

These factors may have contributed to the shift in 2016 from entry queues to redemption queues at year end. So, while the ODCE funds were designed to offer diversification and low risk, we need to keep a close eye on these "canaries in the mines" since they may be taking on more risk than investors bargained for. And for investors trying to forecast future investment activity, the ODCE funds may also prove to be an excellent barometer for the overall state of global institutional RE market capital flows.

Conclusion

We hope that our observations provide food for thought as you consider your investment strategies and long term portfolio planning. We wish everyone the greatest success in the year ahead!

Hodes Weill & Associates

Hodes Weill & Associates ("Hodes Weill") is a real estate advisory boutique with a focus on the investment and funds management industry. The firm is headquartered in New York and has additional offices in Hong Kong and London. Founded in 2009, Hodes Weill provides institutional capital raising for funds, transactions, co-investments and separate accounts; M&A, strategic and restructuring advisory services; and fairness and valuation analyses. Clients include investment and fund managers, institutional investors, lenders, property owners and other participants in the institutional real estate market. The Partners of Hodes Weill have 150+ years of institutional real estate experience across many disciplines including investment banking, restructuring, advisory, institutional capital raising and principal investing.

The Partners leverage their deep skill set and a global network of relationships to provide advice and solutions to a wide range of complex situations impacting the real estate investment and funds management industry. Hodes Weill is employee owned and managed.

Hodes Weill is also co-sponsor of and advisor to Tunbridge Partners, LLC, an asset management company focused on making minority equity investments in real estate- and real asset-focused investment managers.

Further information about the Company and backgrounds for the professional team can be found on the Company's website at www.hodesweill.com or by calling 212-867-0888.

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