CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

Real Estate Debt Has the Potential to Outperform Core Equity

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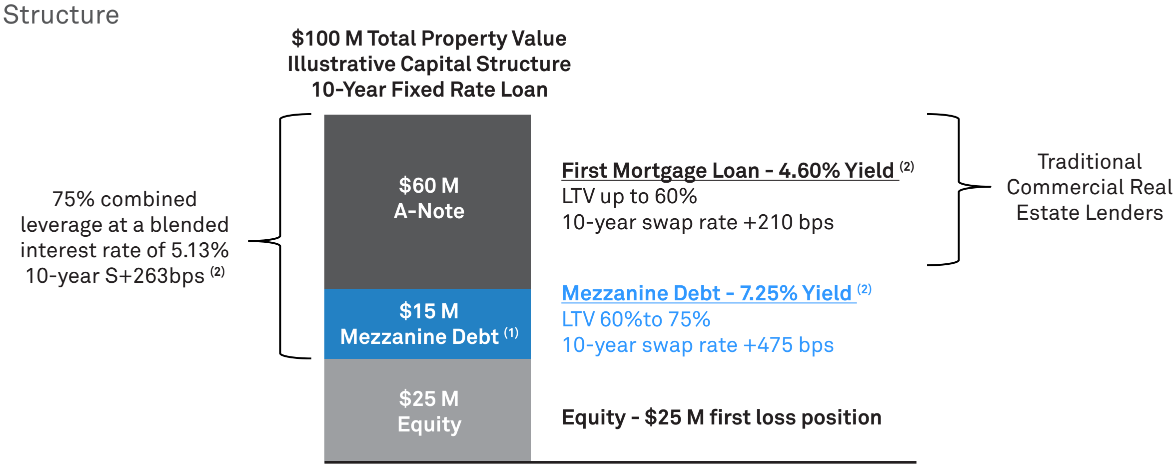
Investors' response to the continued deceleration in core private equity real estate performance has been to seek alternative real estate exposures, including the evolving asset class of private real estate debt. The retreat by traditional lenders in response to increased regulation and general risk aversion has led to an investment opportunity that can be accessed through a "core-plus" debt investment strategy – originating mezzanine loans against stabilized, institutional quality assets. Due to market inefficiencies, we believe that core-plus debt is a mispriced asset class, that has the potential to outperform core equity and broader fixed income returns, with lower risk. Importantly, we believe today represents a timely moment to explore this investment opportunity given what we, and many others, believe is a protracted low return environment.

Core-plus Real Estate Debt

The core-plus real estate debt asset class is relatively nascent, consisting of newly originated mezzanine loans primarily secured by institutionally owned, stabilized office and multifamily properties in economically diverse markets. The largely stabilized nature of the collateral, with contractual cash flows, underpins core-plus debt investments and typically distinguishes it from other forms of real estate debt strategies. Most mezzanine lending strategies call for making subordinated loans secured by highly transitional assets and rely heavily on the success of value-add business plans and/or speculative new construction. The higher quality and more stable collateral base of core-plus debt drives its lower risk profile.

Increased regulation and heightened risk aversion have forced traditional lenders to cap senior loans at around 60-65% loan-to-value (LTV). However, many borrowers still demand higher LTV solutions to implement their real estate investment strategies. To remain competitive and meet this market-driven need, senior lenders may choose to partner with non-traditional real estate lenders to provide the 60-75% LTV component of the capital stack for stabilized, high-quality assets. Low interest rates and high competition for senior loan origination have driven down interest rates for the senior most tranche of the capital stack, and when paired with a core-plus loan, the incremental leverage may only add 50-60bps to the overall borrowing rate[3]. Thus, the core-plus loan holder enjoys a 265 bps premium over the senior lien holder.

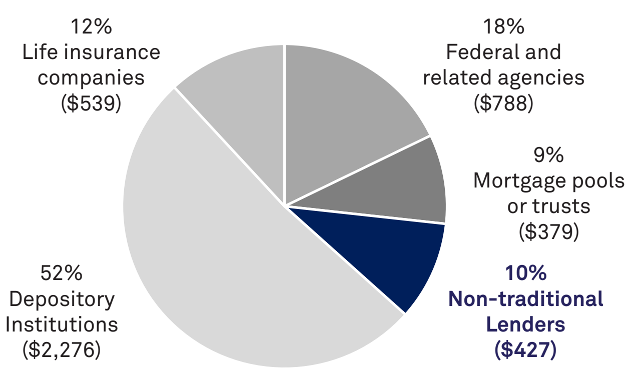
Capital Structure



The above represents an illustrative example of anticipated investments that are expected to fit within the capital structure. Note that the above is presented for informational purposed only and does not represent any specific investments to be made. There can be no assumption that similar investments will contain a capital structure as illustrated above. ***Refer to numerical footnote references on page 5.***

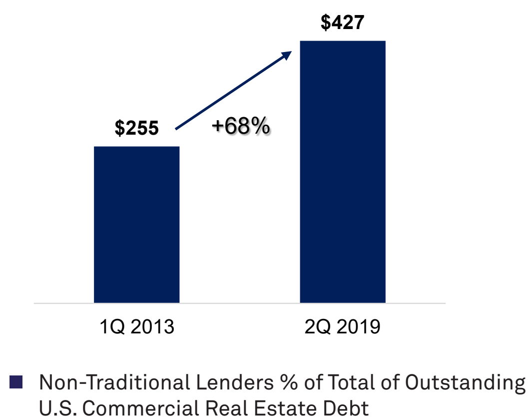
While banks and life insurance companies comprise most of the $4 trillion commercial real estate debt market, non-traditional lenders have grown by 68% since 2013 as they have filled the funding gap left by banks' retrenchment from new lending.

Outstanding U.S. Commercial Real Estate Debt ($B)



Source: Board of Governors of the Federal Reserve System, as of 2Q19

Growth in Non-Traditional Lending ($B)



Source: Board of Governors of the Federal Reserve System, as of 2Q19

Potential to Outperform Real Estate Equity

The end of cap rate compression, coupled with a catch-up in supply that is diminishing NOI growth, has driven a significant deceleration in private real estate returns. Forecasts are for core real estate equity to deliver total gross returns of only 5.3% in 2020 and 4.5% in 2021[4] in contrast to expected core-plus debt unlevered net returns of 6-8%[5]. Core-plus debt hence has the potential to outperform equity with lower levels of risk. In fact, on an LTV basis (given a loan cut-off of 75%) or net income basis (1.4x DSCR), declines of ~25% in values or ~30% in operating NOI would be required before risking impairment for a core-plus debt investment.

Core-Plus Debt has the Potential to Outperform Real Estate Equity with Downside Protection

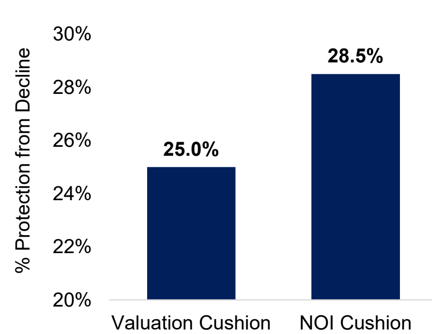
Core Equity Investment Returns [6]

	Annual Rent Growth	0.0%	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%
	Cumulative Rent Growth	0.0%	3.0%	6.2%	9.3%	12.6%	16.0%	19.4%	22.9%
Exit Cap Rate	4.5%	7.7%	8.3%	8.8%	9.4%	10.0%	10.6%	11.2%	11.8%
	5.0%	5.9%	6.5%	7.1%	7.7%	8.3%	8.8%	9.4%	10.0%
	5.5%	4.2%	4.8%	5.5%	6.1%	6.7%	7.3%	7.8%	8.4%
	6.0%	2.7%	3.4%	4.0%	4.6%	5.2%	5.8%	6.4%	7.0%
	6.5%	1.3%	2.0%	2.6%	3.2%	3.8%	4.5%	5.1%	5.7%
	7.0%	0.0%	0.7%	1.3%	2.0%	2.6%	3.2%	3.8%	4.4%

Scenario in which core plus debt outperforms core equity

Core equity investment returns based on the following assumptions: 5% going-in-cap rate, 30% LTV, 3% interest rate, 7 year hold period.

Core-Plus Debt Downside Protection [7]

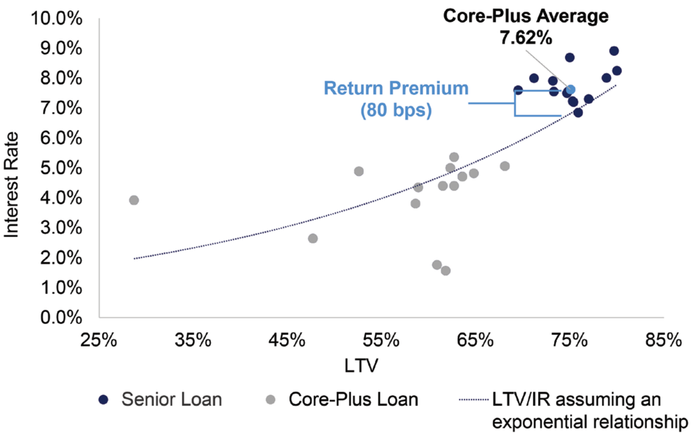


A Mispriced Asset Class

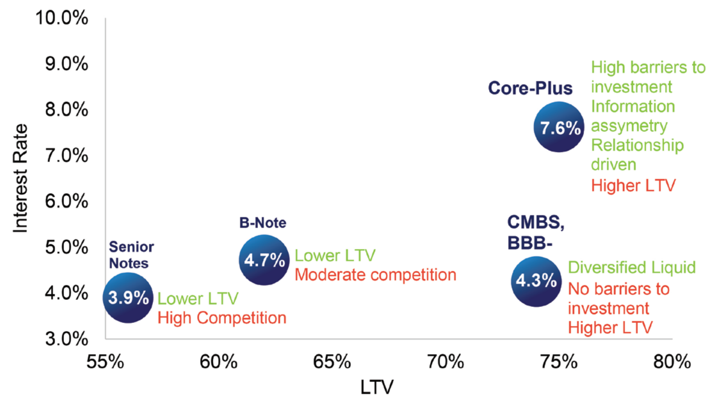
We believe core-plus debt is a mispriced asset class, offering returns approximately 80bps higher than implied senior loan pricing. This core-plus yield premium is being driven by three primary reasons. First, skilled lenders are able to identify potential opportunities to make mezzanine loans in the face of imperfect information, creating a return premium. Second, in the unlikely event of a default, the fact that the mezzanine lender is equipped to foreclose on the equity and can operate the real estate thereafter, means that the senior lender's consideration when choosing a mezzanine capital partner is not only based on the lowest price, but also the ability of the mezzanine lender to operate the real estate and protect the senior lender's investment, which may allow a mezzanine lender to extract a return premium. And lastly, senior lenders may choose to not warehouse mezzanine loans in advance of a securitization and will pay a premium to shift some of the risk at closing of the loan.

We believe the risk-return profile of real estate debt, which is supported by its historical return profile (with only two years of negative returns in the last 47 years – 1974 and 2008)[8] and the high levels of income from the asset class, make core-plus real estate debt an attractive investment opportunity relative to other types of real estate and fixed income alternatives.

Return Premium [9]



Fixed Income Real Estate Investments [10]



We believe certain key components drive success for non-traditional lenders:

1. Reputation matters. For borrowers and senior lenders alike, certainty of execution is key. Investors known as sophisticated, pragmatic, and reliable lending partners enjoy a meaningful edge in an otherwise competitive market.

2. Robust deal origination pipeline. Not all investors are able to access this niche segment of the commercial real estate investment marketplace. Those with longstanding relationships and established inter-creditor agreements with senior lenders can maintain a robust pipeline of actionable opportunities.

3. Underwriting with perspective. Investors with a successful, long-dated record of investing in the space are most likely to correctly identify conditions necessary to create and maintain asset-level value over longer time horizons.

Where to Make the Allocation to Core-plus Debt

Investors are increasingly questioning the allocation bucket for real estate debt – private credit or private real estate? Just as corporate private equity is distinct from real estate private equity, the specialization required to successfully underwrite debt written against real property versus debt written against operating companies points to the likelihood that the team underwriting the equity component of the real estate capital stack is the most logical team to assess real estate debt investments . Academic research also suggests that while senior debt behaves more like fixed income, mezzanine debt shares characteristics of the underlying real estate[11]. As such, it is more appropriate for mezzanine real estate debt to be housed within the strategic asset allocation mix of real estate. Furthermore, real estate debt is another tool available for real estate investors and, the fact that debt returns are uncorrelated with other real estate strategies, provides diversification benefits to a real estate allocation. In fact, real estate investors are increasingly including real estate debt within their strategic allocation, representing a 5% allocation today that we expect will grow.

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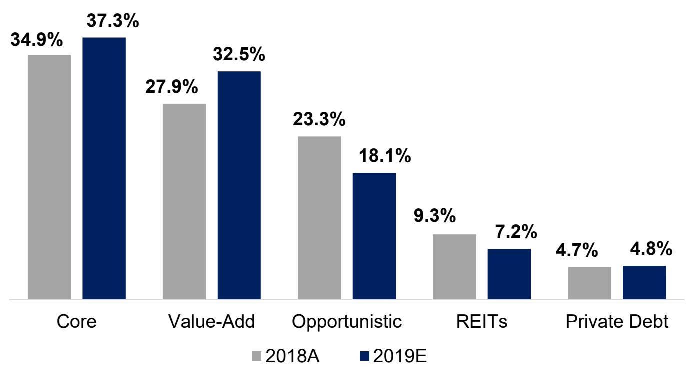
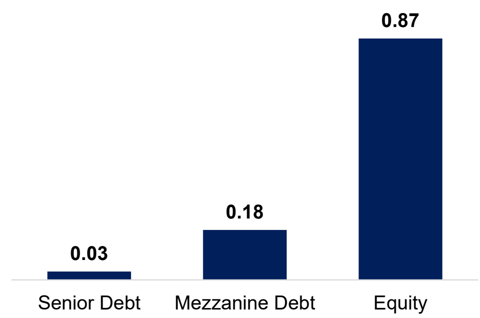
Expected Capital Flows to Real Estate [12]



Correlation of Senior Debt, Mezzanine Debt, the Equity Position, and the Underlying Real Estate [13]



[1] *Can take the legal form of either B-Note or mezzanine loan.*

[2] *Rate assumes a 2.5% swap rate.*

[3] *Based on market pricing represented in the illustrative capital stack below.*

[4] *PREA Consensus Forecast Survey – Q3 2019.*

[5] *CenterSquare Investment Management as of January 2020; target returns are presented for purposes of (a) Lending insight into the investment objectives, relative to the anticipated risk and reward characteristics; (b) Helping to facilitate comparisons with other investment opportunities and (c) Assisting in future evaluations of the vehicle's actual performance. The target returns are not a prediction, projection, or guarantee of future performance. They are based upon general assumptions regarding future events and conditions, which may not prove to be accurate including asset-based returns, investment pacing and management fees. An individual investor's returns could be materially different. Accordingly, the target returns should not form the primary basis for investment decisions.*

[6] *CenterSquare Investment Management as of January 2020.*

[7] *CenterSquare, based on 75% position within the capital stack. 1.4x DSCR is the current weighted average DSCR in the RCG Longview Core Plus Debt II Portfolio.*

[8] *The Giliberto-Levy Commercial Mortgage Performance Index has had only two years of negative returns since inception – 1972 and 2008.*

[9] *RCG Longview. Implied core plus debt interest rates vs loan-to-value (LTV) and implied senior debt interest rates vs. loan-to-value (LTV) based on loans on properties held in an RCG Longview existing Core Plus Debt Portfolio as of December 31, 2019. The Core Plus Debt portfolio consists of 14 core-plus debt investments through a single separate account.*

[10] *CenterSquare Investment Management estimate of current interest rates and LTV cut offs for other relevant real estate related fixed income investments based on the current market environment as of January 2020.*

[11] *van der Spek, Maarten, Investing in Real Estate Debt: Is it Real Estate or Fixed Income? (September 2017). Abacus, Vol. 53, Issue 3, pp. 349-370, 2017.*

[12] *2019 Institutional Investors Real Estate Trends.*

[13] *van der Spek, Maarten, Investing in Real Estate Debt: Is it Real Estate or Fixed Income? (September 2017). Abacus, Vol. 53, Issue 3, pp. 349-370, 2017. Assuming 60% senior debt, 10% mezzanine debt, and 30% equity.*

Disclosure Statements and Risk Factors

Disclosure Statements

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Because the investment strategies concentrate their assets in the real estate industry, an investment is closely linked to the performance of the real estate markets. Real estate is a cyclical business, highly sensitive to general and local economic developments and characterized by intense competition and periodic overbuilding. Real estate income and values may also be greatly affected by demographic trends, such as population shifts or changing tastes and values. Companies in the real estate industry may be adversely affected by environmental conditions. Government actions, such as tax increases, zoning law changes or environmental regulations, may also have a major impact on real estate. Changing interest rates and credit quality requirements will also affect the cash flow of real estate companies and their ability to meet capital needs.

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Definition of Indices

CRE Private Debt: Giliberto-Levy Commercial Mortgage Performance Index

Giliberto-Levy Commercial Mortgage Performance Index

The Giliberto-Levy Commercial Mortgage Performance Index (“G-L Index” or “GLCMPI”) measures the investment performance of select private-market investments in commercial real estate debt. Specifically, the Index tracks fixed-rate, fixed-term senior loans that are made by and held in the investment portfolios (“on balance sheet”) of institutional lenders such as life insurance companies and pension funds. When creating the Index in 1993 our aim was to provide a total rate of return that tracked income, price movements and credit effects.

This benchmark is a broad-based index which is used for illustrative purposes only. The investment activities and performance of an actual portfolio may be considerably more volatile than these indices and may have material differences from the performance of any of this index.

About CenterSquare

Founded in 1987, CenterSquare Investment Management is an independent, management-owned real asset manager focused on listed real estate, private equity real estate, private real estate debt and listed infrastructure investments. As an investor and manager, our success is firmly rooted in aligning our firm's interests with those of our clients, partners and employees, as well as our commitment to alpha-generating research.

CenterSquare Investment Management is headquartered in suburban Philadelphia, with offices in New York, Los Angeles, London and Singapore. CenterSquare is proud to manage investments on behalf of some of the world's most well-known institutional and private investors.

About the Authors

Michael Boxer, *Managing Director, Private Real Estate*

Michael Boxer is a Managing Director at CenterSquare Investment Management and is responsible for supervising the RCG Longview investment management platform. As a member of RCG Longview's investment committee, Mr. Boxer has played a primary role in the creation of RCG Longview's debt and equity funds as well as its joint venture investments in multifamily and workforce multifamily housing. Prior to joining RCG Longview, Mr. Boxer negotiated and structured the disposition of real estate and real estate related assets on behalf of institutional lenders at Victor Capital Group. Mr. Boxer began his career as a real estate attorney with Shea & Gould, where he represented owners and lenders in the structuring and consummation of real estate development, leasing and financing transactions. Mr. Boxer holds a Bachelor of Arts degree from Franklin & Marshall College and a JD from New York University School of Law.

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Richard Gorsky is a Managing Director at CenterSquare Investment Management and a member of RCG Longview's investment committee. Mr. Gorsky's responsibilities include overseeing all the investment related activities of RCG Longview, such as deal origination, structuring, underwriting, and asset management. Mr. Gorsky has previously served on the Economic Development Committee of the Real Estate Board of New York and taught as an adjunct professor at New York University's Schack Institute of Real Estate. Before joining the RCG Longview platform in 2003, Mr. Gorsky was Vice President at Belvedere Capital Management, LLC, working on all aspects of various real estate transactions. Prior to joining Belvedere, Mr. Gorsky was an analyst and controller at Scott Cove Capital Management, LLC, an investment manager of corporate distressed debt and equity. Mr. Gorsky also previously worked as a senior auditor for Ernst & Young LLP. Mr. Gorsky has a Master of Business Administration in finance from New York University Stern School of Business and a Bachelor of Science in Accounting from the State University of New York at Albany. Mr. Gorsky has also received a license as a Certified Public Accountant.

Scott Crowe, *Chief Investment Officer*

Scott Crowe is the Chief Investment Strategist at CenterSquare Investment Management and joined the firm in 2015. Scott is a member of CenterSquare's listed real estate, listed infrastructure and private real estate investment committees. In this capacity he works with each team's portfolio managers and investment professionals in the leadership of the investment process, with a particular focus on thought leadership by synthesizing our real asset views across the business. Scott is the portfolio manager of the Global Concentrated real estate securities strategy. Scott also works directly with CenterSquare's clients, providing education and guidance on the market and helping them execute their investment goals. Prior to joining CenterSquare, Scott was CIO of Liquid Alternatives at Resource Real Estate where he built and led a global investment and distribution platform. Prior thereto, Scott was the lead Global Portfolio Manager for Cohen & Steers, where he was responsible for $10B in assets under management and led the investment and research team of over 20 portfolio managers and analysts. Prior to this, Mr. Crowe held the position of Head of Global Real Estate for UBS Equities Research, where he built and managed the U.S. REIT division while leading a global team of more than 40 analysts. Scott began his career at Paladin Property Securities and holds an Honors Finance Degree from the University of Technology Sydney and a Bachelor of Commerce from the University of NSW/National University of Singapore.

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Ms. Pattarkine is an Investment Strategy Analyst for CenterSquare Investment Management. She joined the team in 2017 and focuses primarily on top down analysis, research and product development, and is an active member of the public side research effort. Prior to joining CenterSquare, Ms. Pattarkine spent three years in corporate strategy and planning at ExxonMobil in Houston. Ms. Pattarkine graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a BS in Finance with a minor in International Business, BS in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute.

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