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The Alternative Real Estate Revolution

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Long before the COVID-19 crisis, the manner in which we live, work and play was already shifting in meaningful ways. Driven by demographics, technology, and evolving preferences over the last decade, the built environment has also evolved, and continues to do so. As a result of these changing demand patterns, alternative property types have arisen and today represent what we believe to be an increasingly important component of the future real estate market. Assets such as data centers, cell towers, single-family rentals, life sciences labs and cold storage facilities are poised to benefit from secular tailwinds. Yet, these properties often require more sophisticated management platforms, with a heavier focus on specialized development, operations, and human capital. In response, the REIT market has embraced these complexities at a pace that is years ahead of traditional "core" private real estate strategies, thus becoming the optimal gateway for investors to access the alternatives in an efficient manner.

Rising to the Occasion of Accelerating Demand

One does not need to search long to find examples of these alternative platforms. Institutional single-family rental properties emerged out of the Global Financial Crisis as distressed mortgages and provided opportunities to accretively amass large portfolios. This asset class differs from its multifamily peers, consisting of geographically distributed portfolios and individually unique properties, all which present an operational challenge to the manager. Here, REITs bring the value of a platform with robust revenue management, customer acquisition, and operational expertise to a national portfolio. These REITs are meeting a demand that continues to expand as aging millennials with growing families still demonstrate a higher propensity to rent rather than own. The uncertainty of COVID-19 only reinforces this trend.

In another example, we see a seismic transition in the demand for IT infrastructure. As we move from the digital age to the virtual age, populations will not only rely on the electronic delivery of information but will also begin to demand the electronic delivery of experiences. As advances in technology increasingly allow us to enjoy virtual reality in more situations, our need to go into an office, attend a sporting event, or visit a doctor in person will diminish over time. While this evolution will result in lower demand for physical real estate, it will increase the secular growth of the data centers and cell towers required to power the rapidly expanding grid. With capacity and bandwidth pressures, investments into this infrastructure can be expected to continue in earnest. Here also, REITs provide the value of a strong platform with global connectivity and the niche operational expertise to succeed.

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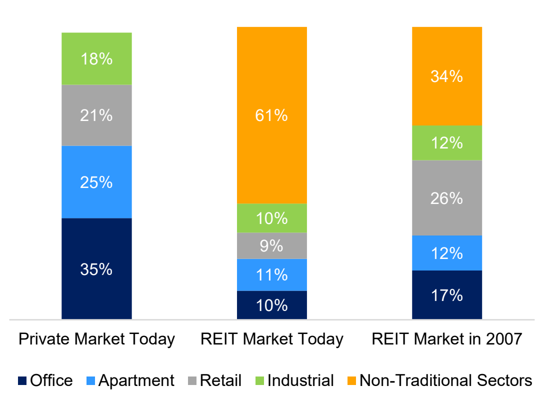
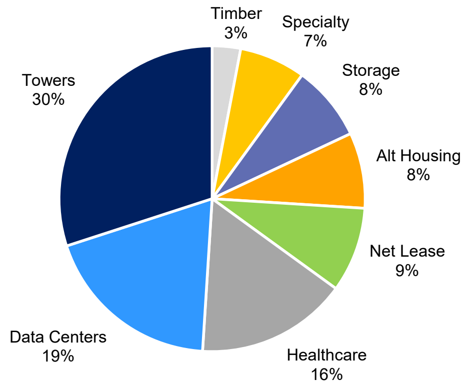
Access to alternative property types is difficult to achieve via core private real estate strategies alone, where today more than 55 percent of the assets comprise office and retail. These two sectors are going to face significant challenges brought on by behavioral shifts already in progress and which have only been accelerated by COVID-19. In contrast, the REIT market has more than 60 percent exposure to alternative sectors, showcasing an impressive evolution that has taken place since before the Global Financial Crisis when these sectors only represented about a third of the REIT market.

Figure 1: Public vs. Private Market Composition



Source: Bloomberg; NCREIF Property Index (Private Market), FTSE Nareit Equity REITs Index (REIT Market), as of December 2019.

Figure 2: Non-Traditional Sector Composition



Source: CSIM and FNER Index, as of June 30, 2020.

We believe part of this evolution has been driven by the pressures of the equity markets, which have compelled REITs to further develop their competitive advantages in several meaningful ways over the last decade. Capital has consolidated with better management teams, higher quality assets, and best in class business models, propelling the REIT market to evolve more quickly than the private markets and positioning them well for the future.

The New "Core"

The REIT market not only offers access to evolving property types but also offers insights into evolving real estate valuations. For instance, it was as early as 2016 when the REIT market started to imply significant shifts in cap rates for retail versus industrial. Here, the impacts of demand patterns have evolved rapidly, creating an existential change in how real estate is valued. Key aspects of value like landlord pricing power and accretive vs. non-accretive capital expenditures have shifted between different real estate sectors. These shifts have favored alternative sectors.

A current example can be found in the office sector, where secular trends have created headwinds for traditional landlords. Tenant needs for quality space have evolved and accelerated amidst COVID-19 into demands for healthy workplaces with effective airflow systems, touchless entryways and configurations that promote social distancing. Simultaneously, the remote workforce — or at least a portion of it — will remain intact, reducing occupancy needs and placing downward pricing pressure on landlords. Capital expenditures, especially for older spaces, are being deployed defensively just to remain relevant.

On the contrary, companies are finding their dollars being better spent investing in their data centers, where the demands for usage and processing speed are increasing exponentially. Here, we will see higher rents, with accretive capital expenditures creating value over the long term. As these types of evolutions take place, it begs the question – what is a "core" investment today? Is it a physical office and shopping mall? Or is it the data center and industrial building enabling cloud processing and ecommerce supply chain execution? Investors who do not respond to these shifts and fail to address a potential overallocation to "traditional core" strategies may find themselves standing in an obsolescent footprint and on the wrong side of history as the world continues to evolve.

The REIT market has ascribed valuations to these evolving trends much more rapidly than the private market. For many of these alternative sectors, the REIT market is imputing lower cap rates than the private market. On the other hand, compared to the private market, the REIT market is discounting those core

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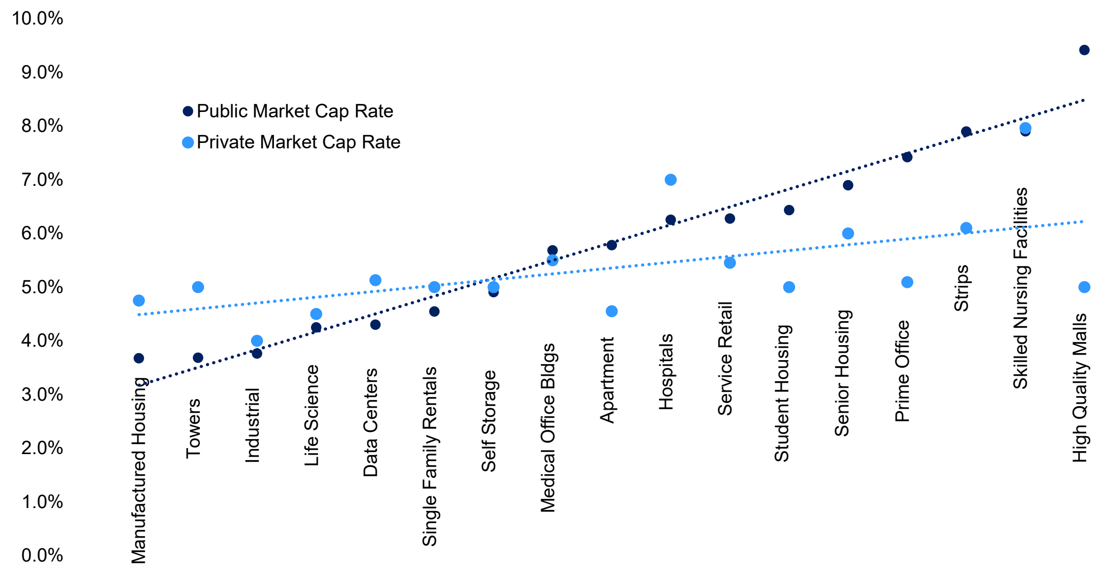
sectors with significant structural headwinds. Increasingly, the REIT market has demonstrated that, in the case of a persistent valuation gap, the public market tends to be more directionally correct in real estate price discovery.

Figure 3: Traditional vs. Non-Traditional Real Estate Pricing



Source: Bloomberg and CSIM as of August 2020

Completing the Portfolio of the Future

Not only do REITs have the broader menu from which to choose, but they also offer an efficient way to access these opportunities. Investors can complement existing "core" property portfolios with a "REIT Completion" strategy. This approach, which involves investing in a customized REIT portfolio alongside a private strategy, can be used to achieve two primary objectives: (1) an access objective, which grants exposure to alternate real estate sectors that are difficult to find in the private markets, and (2) a valuation objective, which helps achieve pacing goals while taking advantage of REIT pricing discounts to private-market valuations.

Hypothetical REIT Completion Portfolio Comparison

Figure 4: Annualized Historical Performance

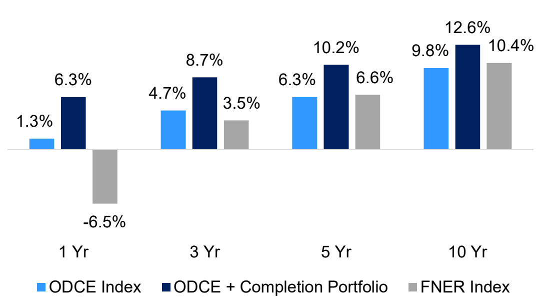
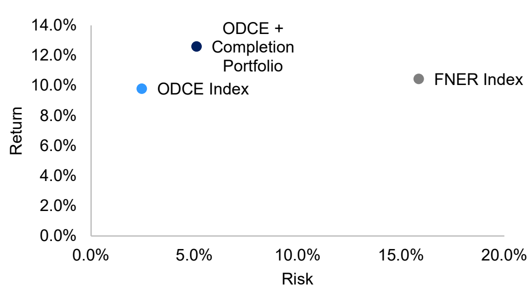


Figure 5: Annualized Risk / Return



Source: CSIM and NCREIF, as of June 30, 2020. ***Past performance is not indicative of future results.*** *Hypothetical completion portfolio comprises 80% ODCE and 20% public holdings with sector weights based on market caps of stocks in the FNER (All Equity REIT) Index.*

No representation is being made that CSIM will or is likely to achieve results comparable to those shown, to make any profit at all, or to be able to avoid incurring substantial losses. There can be significant differences between hypothetical performance results and the actual results subsequently achieved by any particular investment strategy.

A successful REIT completion strategy can complement a private real estate investment portfolio. As demonstrated in the hypothetical scenario above, the ODCE[1] index combined with a REIT completion portfolio outperforms both the standalone ODCE index and the FNER[2] index across all time horizons, with a minimal increase in risk.

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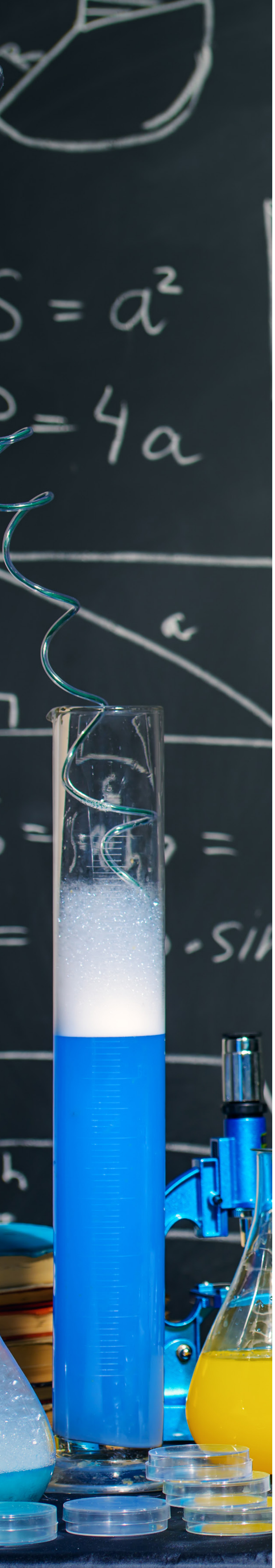

Conclusion

The rationale to invest in the REIT market has expanded, and now provides investors with an opportunity to reposition portfolios by accessing alternative growth sectors. Price discovery amid COVID-19 and the global recession have begun to take place in the listed market; REITs are trading at a substantial discount to what are likely stale private-market valuations. All these factors reinforce the REIT value proposition for those investors engaged in a listed strategy today, and create a timely opportunity for those considering a tactical shift. Either way, investors have a clear choice as to how they wish to be positioned and should be mindful not to be left behind a revolution already underway.

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[1] *Open End Diversified Core Equity (ODCE) Index illustrates a private real estate investment strategy.*
[2] *FTSE Nareit Equity REITs Index (FNER) illustrates a public real estate (REIT) investment strategy.*

About the Authors

Scott Crowe, *Chief Investment Strategist*

Scott Crowe is the Chief Investment Strategist at CenterSquare Investment Management and joined the firm in 2015. Scott is a member of CenterSquare's 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. Additionally, Ms. Pattarkine serves as the Firm's Global ESG Coordinator, engaging both internally and externally on ensuring ESG considerations are embedded into CenterSquare's investment process. 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, member of the CFA Institute and a LEED Green Associate.

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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. Investing in the equity securities of real estate companies entails certain risks and uncertainties. These companies experience the risks of investing in real estate directly. 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.

Hypothetical Performance

Hypothetical or simulated performance results presented have certain inherent limitations and actual results may differ. The hypothetical portfolio simulation presented does not reflect investment management fees. Unlike an actual performance record, simulated results do not represent actual investments. Simulated performance in general is also subject to the fact that they are designed with the benefit of hindsight. Also, since investments have not actually been executed, the results may have under or over compensated for the impact of certain market factors. In addition, hypothetical investing does not involve financial risk. No hypothetical investment record can completely account for the impact of financial risk in actual investing. For example, the ability to withstand losses or to adhere to a particular investment program in spite of the losses are material factors which can adversely affect the actual results. There are numerous other factors related to the economy or markets in general or to the implementation of any specific investment program which cannot be fully accounted for in the preparation of hypothetical performance results, all of which can adversely affect investment results. The total returns presented are gross of investment management fees. Fees will reduce investor returns. For example, an account with a compounded annual return of 10% would have increased by 159% over 10 years. Assuming an annual advisory fee of 0.85%, this increase would be 140%.

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Disclosure Statements Continued

CenterSquare REIT Cap Rate Perspective Methodology
CenterSquare REIT Implied Cap Rates are based on a proprietary calculation that items by the value of its equity and debt less the value of non-income producing assets. The figures above are based on 3Q20 earnings reported in September 2020. The universe of stocks used to aggregate the data presented is based on CenterSquare's coverage universe of approximately 200 U.S. listed real estate companies. Sector cap rates are market cap weighted. Sectors and market classifications are defined by the following: Apartment: REITs that own and manage multifamily residential rental properties; Industrial: REITs that own and manage industrial facilities (i.e. warehouses, distribution centers); Office – REITs that own and manage commercial office properties; Retail – REITs that own and manage retail properties (i.e. malls, shopping centers); Hotel– REITs that own and manage lodging properties; Healthcare – REITs that own properties used by healthcare service tenants (i.e. hospitals, medical office buildings); Gateway – REITs with portfolios primarily in the Boston, Chicago, LA, NYC, SF, and DC markets; Non-Gateway – REITs without a presence in the gateway markets. The REIT ODCE Proxy is a universe of REIT stocks built to resemble the NCREIF Fund Index – Open End Diversified Core Equity (ODCE). The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The REIT ODCE Proxy is proprietary to CenterSquare and uses gateway/infill names in apartments, retail, industrial and office, and then weights them according to the ODCE index to create a proxy.

Private Market Cap Rates represent the cap rate achievable in the private market for the property portfolio owned by each company, and are based on estimates produced by CenterSquare's investment team informed by various market sources including broker estimates.

Definition of Indices

FTSE Nareit Equity REITs Index "FNER" The FTSE Nareit US Real Estate Index Series is designed to provide the most comprehensive assessment of overall industry performance, and includes all tax qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market List. The index constituents span the commercial real estate space across the US economy and provides investors with exposure to all investment and property sectors. 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.

ODCE: NCREIF Open End Diversified Core Equity (ODCE) Index The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s.

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A direct investment in an index is not possible.

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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.

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