CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

POWERED BY AGILITY

2024 Strategic Capital Outlook

Powered by Agility

In a world of meaningful market dislocation, the marketplace is rife with opportunities for investors possessing the ability to be nimble and creative. This has never resonated more than it does today for our strategic capital platform, which was developed to capitalize on the white space that exists between the traditional real estate investment strategies (REITs, private equity real estate, private debt real estate). Through investments in real estate companies and platforms positioned for growth, this is the ideal hunting ground for thematically driven investments poised for transformational development and value creation across property sectors and the capital stack. While 2023 was a year of uncertainty, we believe the coming year will prove to be an ideal environment where pressures will exacerbate the need for new capital that can be deployed in unique ways to take advantage of the resetting real estate cycle.

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Senior Investment Strategist and Global ESG Lead

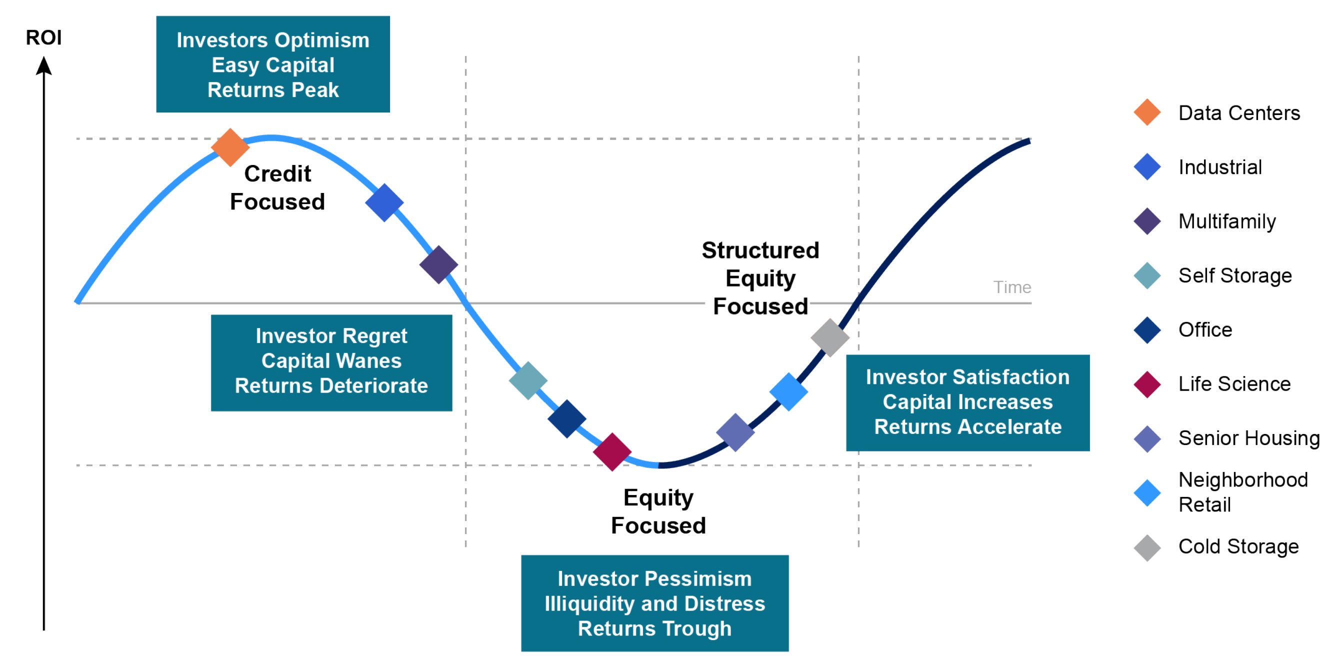
Capital Cycle Framework

A frequent topic of discussion around investment teams recently has been about the current economic cycle – whether the U.S. economy can manage to skate past the aggressive monetary tightening without an economic slowdown. Data has been oscillating between showing strength and weakness, providing ammunition for the bulls and bears in the market. While we can point to many leading indicators that have historically been predictors of economic cycles, the exercise of predicting economic cycles can be crowded with material uncertainties associated with the demand side of the equation – consumption has kept the party going for much longer than anyone would have initially expected when the yield curve inverted in 2022.

A different cycle, however, is simpler to understand – the capital cycle – and it's focused on analyzing the supply side of the equation. At the trough of the cycle, capital is scarce and investor sentiment is pessimistic. The lack of capital improves the supply side of the equation, initiating an upturn in returns. These rising returns attract new entrants into the market, offering an abundance of capital, which creates a headwind to the supply side of the equation and causes returns to decline. Rinse and repeat. Thematic investors are particularly susceptible, as their strong convictions can drive valuations to extremes in the pursuit of thematic investment strategies.

Within real estate, especially, the supply impact of the capital cycle can be easily understood and forecasted. For our strategic capital platform, with the capacity to deploy capital in the private markets without being restricted to a property type or deal structure, the capital cycle provides a fantastic framework to understand the opportunity set, both from the perspective of property types and deal structure.

Figure 1: Capital cycle impacts on real estate property types and deal structures



Source: CenterSquare, as of January 31, 2024.

Investing in Platforms

The choice between individual assets and platforms presents a landscape of contrasting advantages and considerations. Opting for individual assets offers control, allowing investors to shape decisions, dictate financing terms, and, with certain lockouts, exercise authority over the timing of asset sales or liquidity creation. However, this path comes with its drawbacks, demanding rapid underwriting of new markets within a tight 30-day window. The process involves understanding partners, conducting due diligence, and securing financing – ultimately bearing the brunt of risk on a singular asset, rendering outcomes more binary. On the other hand, embracing platforms introduces a spectrum of benefits. The luxury of dedicating ample time to underwrite teams, scrutinize backgrounds and track records, and assess existing assets and pipelines enhances decision-making. Diversifying risk across a portfolio of assets mitigates the binary nature associated with individual investments. Moreover, platform investments leverage economies of scale, benefiting from secured financing and efficient entity-level financing akin to the advantages reaped by REITs. However, it's crucial to acknowledge the trade-offs, as platform investments may compromise liquidity and control compared to the familiar terrain of a traditional 90/10 joint venture, even though they offer opportunities to influence strategic decisions at a board level.

We believe the pros vastly outweigh the cons across platform investing, especially across today's thematics, which are more than the real estate of old – a simple model of leasing – but operationally intensive real estate niches that require a unique skillset and a strategic team at the helm. Furthermore, through preemptive rights, investors in these platforms can have the guaranteed option – not the commitment to continue to invest more dollars where there is a high return on investment in the future.

However, not all platforms are created equal. We believe the best platform opportunities will score positively across the following pillars:

- **Quality companies** that are aligned with the secular tailwinds in which we have high conviction.
- **Quality management** with a proven track record of being successful capital allocators with proper alignment of interests.
- **A pathway to liquidity** with exit timing agreed upon closing, that allows sufficient time to create value and capture full market value.
- **Pricing** that offers attractive risk/reward relative to public markets and allows us to be paid for illiquidity and lack of control.

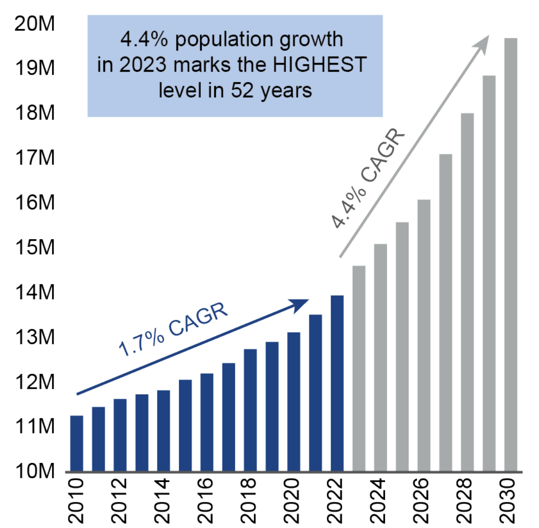
The Hunting Ground

The opportunity set for strategic capital is most compelling in sectors where we believe the intersection of the capital cycle with secular drivers is poised to deliver meaningful tailwinds in the coming years for platforms in growth mode:

Healthcare

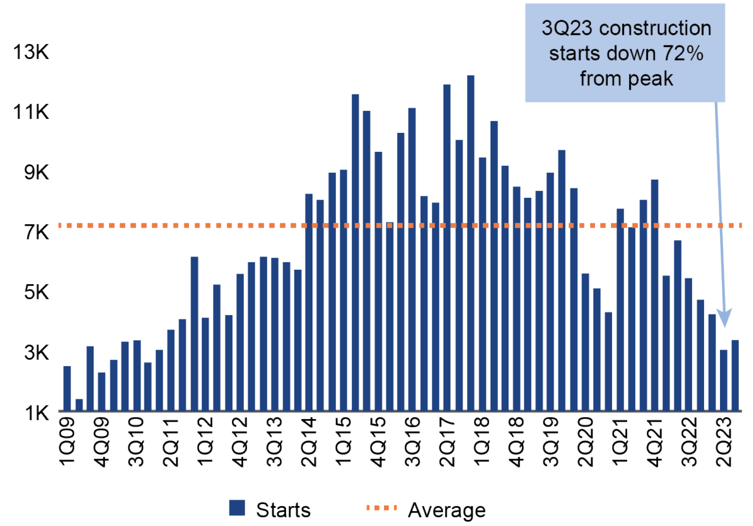
Every day, 10,000 people turn 65 in the U.S. and the number of older adults is expected to represent more than 20% of the population by 2050[1]. The population of 80+ year olds is going to grow by 4.4% annually each year through 2030 (Figure 2), which is the highest level of population growth for this age cohort in over half a century as the baby boomer generation ages. This aging population across the country is expected to increase demand for healthcare facilities, particularly senior housing. This secular demand growth is coinciding with a decrease in supply of senior housing space, as construction starts have decreased over 70% from their peak levels in the middle of the last decade (Figure 3). Furthermore, the meaningful wealth held across the baby boomer generation allows for significant pricing power across the senior housing market with affordability that has increased 2.8 times since 2008 as wealth has increased far above and beyond market rent growth for this property type.

Figure 2: U.S. 80+ Population Growth



Source: Organization for Economic Co-operation and Development, NIC maps, Federal Reserve, Survey of Consumer Finances and Financial Accounts of the United States, as of September 30, 2023.

Figure 3: Senior Housing Construction Pipeline



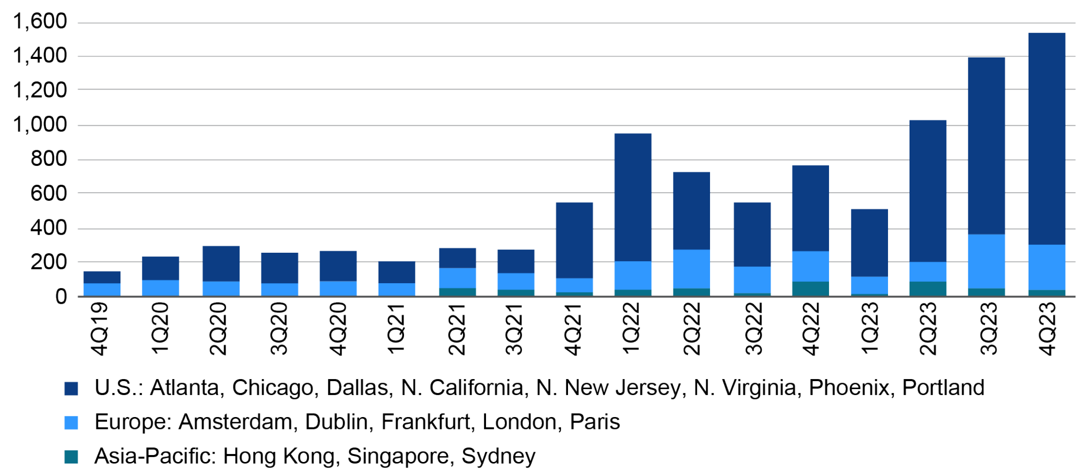
Source: National Investment Center for Seniors Housing & Care, NIC Primary and Secondary Markets, as of September 30, 2023.

[1] https://www.aarpinternational.org/initiatives/aging-readiness-competitiveness-arc/united-states

Data Centers

We covered our bullish thesis for the data center sector in our recent global REIT outlook given the REIT universe's exposure to the world's top global data center platforms. However, the data center opportunity for real estate investors has more recently grown in prevalence across private markets as well. This is especially true for the data center development business. There was a record year of data center leasing in 2023, with leases surpassing 4,500 megawatts, with over 1,500 megawatts signed in the fourth quarter alone (Figure 4). The exponentially increasing demand hasn't gone unnoticed, however, as projected construction in the next five years across the largest data center operators totals more than $100 billion according to the latest Green Street estimates. However, more than 75% of that supply is expected to be pre-leased before construction begins. As companies continue to underwrite and truly understand their data center needs, especially given the advent and growth of Artificial Intelligence, deploying capital across a proven data center development platform remains an attractive opportunity to capture this secular driver.

Figure 4: New leasing activity for top data center markets



Source: datacenterHawk, as of December 31, 2023.
Note: Historical data collection of Asia-Pacific markets did not begin until Q2 2021.

Consolidation in Fragmented Markets

While there are secular demand themes that support opportunities across healthcare and data centers, another attractive area to deploy capital across platforms in real estate comes in the form of identifying platforms that are aggregating assets across a property type where the market is extremely fragmented and not historically institutionalized. Here, the consolidation opportunity provides a notable avenue of growth and value creation for a platform that can deploy an institutional process to successfully consolidate assets and drive economies of scale. Many niche property types lend themselves to this opportunity – self-storage, cold storage, industrial outdoor storage, and essential service retail are just a few.

Liquidity Provider

Most notably, in an environment where capital markets are dislocated – traditional lenders are reducing their proceeds, sellers are holding out hope for pricing of the past, and buyers are continuing to wait for more rational pricing – we anticipate the confluence of these factors to create a unique opportunity for real estate investors in the coming year. Those adept at strategic capital deployment can leverage their resources creatively by serving as liquidity providers in this environment.

This could take the form of providing liquidity within the secondary market for investors in ODCE funds or non-traded REITs with capital needs. Alternatively, investors can seize opportunities arising from the necessary reconstitution of capital stacks in numerous commercial real estate or multifamily deals, originally structured at peak valuations under the assumption of sustained growth and low interest rates. Structuring these types of deals to best capture the impacts of the capital cycle across property types should provide a unique opportunity for strategic deals in the coming year.

The potential issues in the banking system, especially regional banks, associated with CRE loans have once again made the headlines. If you step back, commercial real estate is a unique asset class because investors are looking for a total return from two things – first, there is ongoing cash flow that can look a lot like a bond, with durable cash flow plus the capital appreciation over the long run. This is based on the fact that rents should rise with population growth or secular increased demand and increases in replacement cost. With the rapid increase in rates that we've seen over the past 18 months, both in short-term, and more importantly, long-term rates, it's just a function of math that all else equal asset values have to decrease across the space. As a result, banks are going to have to sell loans to right-size their assets and liabilities or restructure loans that require borrowers to come up with fresh equity for paydowns. It seems we're on this path and there will be an opportunity in size to acquire loans at attractive prices, but it may take some time into 2024 or 2025. Banks most likely will be selling down their consumer loans first, which have higher coupons and shorter maturities or shorter duration and therefore less of a mark-to-market impact because they can sell at a higher dollar price, closer to par. As for commercial real estate loans, just due to math, the consequences will be much more painful because the duration tends to be much longer. So, there will be pain from purely a spread perspective – layer onto that any credit issues you have in sectors like office, and banks will try their hardest to delay bringing out loans into the marketplace until they absolutely have to. Going back to the GFC, you had lenders and special servicers kick the can down the road, and banks and other regulators were largely on board. We had federal government intervention through the TARP program, so the opportunity set will largely be sized based on how accommodative regulatory policy is, which will be further complicated by 2024 being an election year.

As we stand on the cusp of 2024, we pivot toward a future characterized by resetting real estate cycles and a burgeoning need for inventive capital solutions. Whether contemplating the cyclicality of capital, transformative secular trends, or delving into the intricacies of platform investments, the real estate landscape ahead offers opportunities for strategic and unique deals. Investors with foresight and adaptability are poised to succeed in the dynamic real estate landscape ahead.

About the Authors

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Managing Director
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Chad Burkhardt is a Managing Director and is based in the Philadelphia office. Chad serves as a Portfolio Manager for our Private Equity Value-Added Fund Series and leads the firm's Strategic Capital strategy. Since joining CenterSquare in 2013, he has had multiple roles with oversight on acquisitions in the Eastern United States, portfolio management, and serves as a member of the Private Real Estate, Strategic Capital, and Essential Service Retail Investment Committees.

Chad previously led real estate acquisitions for a New York based family office investing in distressed real estate in the United States and Puerto Rico. From 2007 to 2011, he was employed by D. E. Shaw & Co., a multi-strategy hedge fund based in New York, where he oversaw commercial real estate acquisitions, and was responsible for real estate credit, which included the purchase of senior and subordinate debt positions, as well as CMBS and REIT securities. In addition, he was responsible for portfolio management and the disposition of select real estate assets globally. Chad started his career at Merrill Lynch & Co. as a Vice President in Global Principal Investments, the group responsible for investing the firm's balance sheet in commercial real estate debt and equity, with a focus on the Americas.

Chad graduated from Cornell University with a B.S. in Hotel Administration with a concentration in Real Estate Finance and Management. He serves as a Director of NYPEN Real Estate, the Girard College Foundation, and the Revolution School in Philadelphia.

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Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and leads thought leadership across the Firm's public and private real estate platforms. She is part of the listed real estate investment team and serves on CenterSquare's Private Real Estate Debt Investment Committee. Uma leads the Firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston. Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Sustainability Committee. She currently serves on the Board of Directors for Green Building United, the Penn State Smeal Sustainability Advisory Board, and the FTSE EPRA Nareit Americas Regional Advisory Committee.

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Definition of Indices

NCREIF Open End Diversified Core Equity Index

The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity (NFI-ODCE), is the first of the NFI-ODCE 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.

This benchmark is a broad-based index which is used for illustrative purposes only and has been selected as it is well known and easily recognizable by investors. However, the investment activities and performance of an actual portfolio may be considerably more volatile than and have material differences from the performance of the referenced index. Unlike this benchmark, the portfolio portrayed herein is actively managed. Furthermore, the portfolio invests in substantially fewer securities than the number of securities comprising the benchmark. There is no guarantee that any of the securities invested in by the portfolio comprise the benchmark. Also, performance results for the benchmark may not reflect payment of investment management/incentive fees and other expenses. Because of these differences, the benchmark should not be relied upon as an accurate measure of comparison. A direct investment in the index is not possible.

About CenterSquare

Founded in 1987, CenterSquare Investment Management is an independent, employee-owned real asset manager focused on listed real estate, private real estate equity and private real estate debt investments. As a trusted fiduciary, our success is firmly rooted in aligning our interests with those of our clients, partners and employees. CenterSquare is headquartered in suburban Philadelphia, with offices in New York, Los Angeles, London and Singapore. With approximately $13 billion in assets under management (December 31, 2023), our firm and subsidiaries are proud to manage investments on behalf of some of the world's most well-known institutional and private investors.

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