Why Real Estate Private Funds Are Better Positioned for this Downturn.

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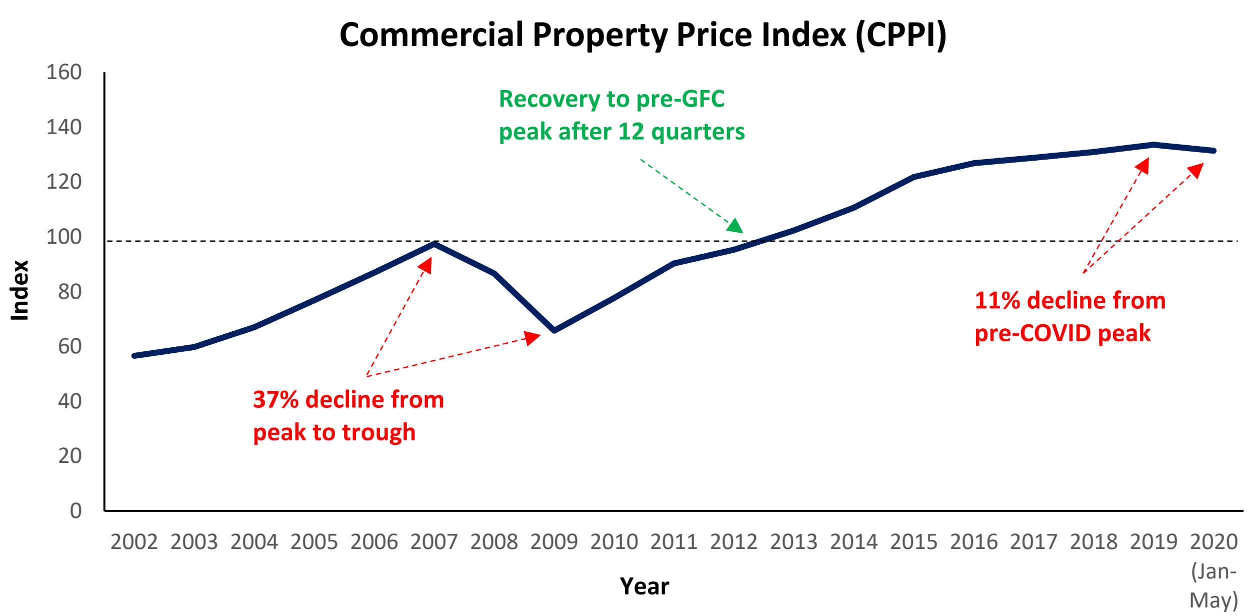
While it is too early to assess the extent of the impact of COVID-19 on the commercial real estate industry, including valuations and operating fundamentals, closed-end real estate equity funds appear better positioned today for a potential market correction than funds that were heading into the Global Financial Crisis (GFC) more than a decade ago.

Portfolio construction, operating practices and fund terms have evolved since the GFC as institutional fund managers and investors acted on lessons learned. Accordingly, today's funds should fare better than those that faced the challenges of navigating the GFC storm. This of course assumes any COVID-19-driven market correction presents fallout comparable to, or less severe than, the industry experienced during the GFC.

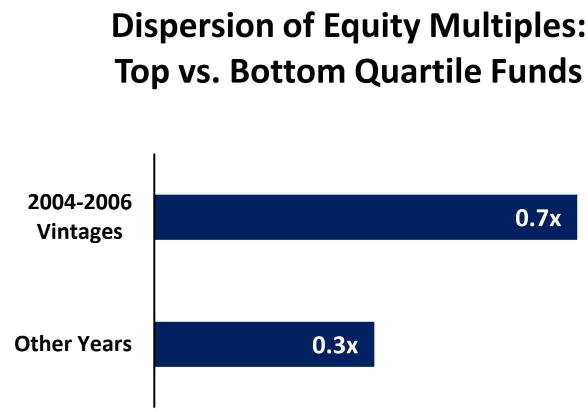
Over the 21 months between August 2007 and May 2009, asset valuations declined by 37% from peak to trough.[1] While property values are reported to have fallen by 11% since the pre-COVID peak, a better proxy of the potential devaluation might be the public markets.[2] According to Green Street Advisors, as of late March 2020 the devaluation of public real estate stocks implied a decline in gross unleveraged values by an average of 25%.[3] The post-GFC plummet in valuations, in a market starved of liquidity, created extreme distress on portfolios in real estate private funds (REPFs). As a result, many poorly-capitalized funds were unable to ride out the storm.



Source: Green Street Advisors, A Real Estate Research Firm, (US) Commercial Property Price Index (CPPI). As of May 06, 2020.

[1] *Green Street Advisors, A Real Estate Research Firm,(US) Commercial Property Price Index (CPPI). As of May 06, 2020.*
[2] *Green Street Advisors, A Real Estate Research Firm, (US) Commercial Property Price Index (CPPI). As of May 06, 2020.*
[3] *Green Street Advisors, A Real Estate Research Firm, Commercial Property Outlook Webinar: #COVID-19, March 17, 2020.*

Unsurprisingly, the investment performance of pre-GFC vintage funds suffered, with 2004, 2005 and 2006 vintages delivering average negative net IRRs and sub-1.0x equity multiples. But the dispersion in returns between top- and bottom-quartile performing funds during this time period was notable, with the delta in equity multiples averaging 0.7x. This compares to an average delta of 0.3x during other years.[4] Funds that were able to manage through the crisis and benefit from the subsequent recovery in portfolio valuations to pre-crisis levels, ended up delivering net positive returns.[5]

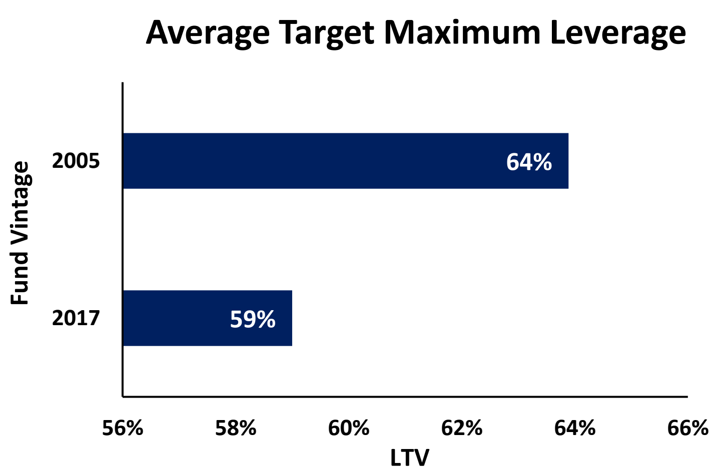


Source: Cambridge Associates Real Estate Index and Benchmark Statistics. Q3 2019.

Now, as property markets face a likely downward correction in valuations, managers and institutional investors are actively assessing the risk profile of their REPF portfolios. But market participants can, and should, take comfort in knowing that REPFs are reasonably well-positioned for this downturn relative to pre-GFC funds. Specifically, changes to practices and terms around leverage, liquidity and fund governance should contribute to a more favorable outcome - if the after-effects of COVID-19 are comparable to those following the GFC.

Leverage

From a balance sheet perspective, funds have significantly less leverage, and managers have taken on debt with much more prudent terms and covenants, in both cases often at the insistence of institutional investors. Higher yielding funds that began investing equity in 2005 had an average target maximum leverage ratio of 64%, which is significantly higher than the equivalent for today's funds, which on average are targeting 59% leverage.[6] Furthermore, the definitions and constraints on fund leverage have, for the most part, been tightened up since the GFC. A good example of a pre-GFC leverage constraint was a "target leverage percentage at the end of the investment period," which effectively allowed managers to use projected future valuations to set



Source: Preqin Data. As of April 24, 2020.

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[4] Cambridge Associates Real Estate Index and Benchmark Statistics. Q3 2019. CA Private Investment Benchmarks are provided at no cost and the data is presented "as is."
[5] Green Street Advisors, A Real Estate Research Firm, (US) Commercial Property Price Index (CPPI). As of May 06, 2020.
[6] Source: Preqin Data. As of April 24, 2020. Defined as 'Value Added' or 'Opportunistic'. Fund Vintage based on date of first investment.

leverage levels, and in many cases did not impose an actual cap. Today, fund leverage provisions are more stringent; an incurrence test based on cost and/or fair market value (FMV) is standard, and typically written as a contractual covenant in limited partnership agreements.

As mentioned above, the poor performance of certain vintage funds was compounded by aggressive leverage strategies heading into the GFC – specifically, the terms of the debt utilized. Such measures included excessive cross-collateralization and imprudent levels of fund-level recourse guarantees. The structure of this debt severely limited the ability of certain managers to walk away from individual properties by simply handing the keys back to lenders or otherwise pursing recapitalizations of "good assets." The limitation on cross-collateralization and recourse in post-GFC funds should substantially limit the risk of bad individual assets dampening portfolio-wide performance.

While some managers of REPFs (whose names will go unmentioned) became poster children for their poor capitalization decisions, the managers that pursued more conservative leverage strategies were able to take a "do no harm" approach during the GFC, or, in some cases, play offense, and their REPFs subsequently recovered well as the property markets stabilized.

Finally, the combination of historically low interest rates and more conservative leverage levels, implies that debt service coverage ratios were more favorable for REPFs pre-COVID, as compared to pre-GFC. However, if net operating income (NOI) decreases by more than 10-20% due to delayed or abated rent payments, even the best-capitalized REPFs may struggle to cover their debt service.

Liquidity

Most funds today have reserved 10-15% of committed capital for supporting follow-on investments, which can be used to play defense and protect portfolios during a downturn. Fund terms have also evolved to make investor capital defaults more punitive and to provide for an enhanced ability to recycle and recapture capital, such as through "LP clawbacks." More proactive liquidity management, these enhancements, and early anecdotal indications of investor appreciation of the need for fund liquidity through waiving, amending or otherwise relaxing limitations on capital recycling and the use of subscription-secured credit facilities, make many funds' liquidity positions today much stronger than those of pre-GFC funds.

Moreover, as a result of more prudent deployment pacing over the past 3-4 years, REPFs today have unprecedented levels of "dry powder" with $335 billion of uninvested equity, as compared to $172 billion in 2007[7].

When combined with the application of more prudent debt, ample reserves and dry powder should enable fund managers to protect their portfolios, and avoid liquidations, at the bottom of the cycle. By comparison, there were numerous examples of pre-GFC REPFs that had invested 100% of committed capital, providing no downside buffer. This subsequently led many managers to pursue distressed sales, and/or highly dilutive equity and debt recapitalizations. As such, some funds were not positioned to recover as the market improved, and consequently delivered poor performance relative to their peers. The alpha of course will likely come from a manager's skill in determining when supportive equity is accretive versus when it is good money after bad.

[7] *Preqin, Dry Powder Data. As of May 06, 2020.*

Governance and Fund Terms

Over the past 12+ years, fund governance and terms have evolved as well. The Dodd-Frank Act, effective March 2012, resulted in many managers of real estate equity funds registering with the SEC; and even for those not captured by the registration requirements, many of these terms have become the market standard. Many of these provisions foster additional transparency, including required disclosures, increased scrutiny and approvals of conflicts, additional reporting, and limitations on termination fees.

Fund terms and governance provisions in many limited partnership agreements have incorporated tighter constraints and rights for investors. For example, portfolio construction provisions have been fine-tuned, typically around asset-type, risk/return stage, geographic and other market concentration limits. Consequently, fund portfolios are more balanced and broadly diversified and have, on average, less exposure to concentrated risk. As an aside, it is worth pointing out that some of this concentration risk may have been moved from funds and into co-investments alongside funds; thereby lessening, but not eliminating the risk.

An evolution of fund terms has further supported the partnership between managers and investors, and the balance of manager control and investor checks and balances should bolster the ability of REPFs to weather a downturn. For example, advisory committees typically have more granular rights and oversight as compared to those typically seen a decade ago. This includes both enhanced reporting, transparency, advisory committee voting and notification rights. Coupled with these on-going operational-type rights, many of today's funds include no-fault commitment period termination rights, no-fault liquidation rights and/or general partner removal rights, thereby effectively balancing the negotiating table between GPs and LPs.

Improved investor checks and balances, coupled with early indications that investors remain supportive of GPs' portfolio management capabilities, should serve funds well.

In summary, while the severity of this potential downturn remains uncertain, performance of REPFs will undoubtedly suffer if there is a market correction (which most industry participants are anticipating), REPFs should be better positioned this time on a number of fronts than after the GFC. Funds are more conservatively-capitalized and the closed-end fund model has been improved, with many of its fundamental attributes well-designed for the illiquid and cyclical nature of real estate assets. Ultimately, in this market like all others, alpha will be generated from manager and investor decisions. Whether a manager invests additional or follow-on equity versus handing over the keys to a lender, or whether investors exercise a no-fault liquidation or removal right, will always be decisions made in the face of uncertainty (but will undoubtedly appear obvious with the benefit of hindsight). Proactive measures taken from lessons learned following the GFC should, however, make stakeholders less hamstrung in making tough calls and hopefully enable them to ride out a storm looming on the horizon.