HIGHTOWER
Bethesda

Private Real Estate

Hightower Bethesda

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An Alternative Approach to Investing: Private Real Estate

This asset class is for investors seeking alternative sources of income and growth other than through traditional investments in the equity and bond markets. Private Real Estate is generally defined as tangible property consisting of land, buildings and improvements to these holdings. At Hightower Bethesda, we have found current income from stabilized core properties to be a great supplement for income in our clients' portfolios.

Private real estate is not publicly traded real estate investment trusts (REIT's). REITs have historically demonstrated increased market volatility, and may not provide the diversification desired by an investor relative to equities *(Mercer, Real Estate Overview 2019)*.

Instead, private real estate encompasses investment opportunities that are not available on the publicly traded exchanges. Many commercial properties are owned by commingled investment funds, large institutional investors, and high/ultra-high net worth investors.

Real estate is commonly described by investment profile, sector, and market. Each category within real estate investing has a different risk and return profile as well as liquidity constraints to consider.

Private REIT investments are made through Limited Partnerships (LPs) and generate a K1 for tax reporting purposes to the individual investors. Some private real estate investments generate income for investors; generally, a portion of this income is non-taxable, based on the ability to shield a portion of that income through depreciation and return of capital. When properties are sold in the future, the depreciation is recaptured, but the taxable portion will then be taxed at long-term capital gain rates, as opposed to ordinary income tax rates.

Types of Investments

Private real estate investments are generally made through the following structures:

- Direct transaction for a single property
- Direct acquisition of a portfolio of real estate assets
- Diversified commingled fund - Generally structured as limited partnerships or REITs, where the investment managers (General Partners or "GPs") oversee the investment of the fund's assets and manage the day-to-day operations. LPs supply the capital and seek to benefit from the skill of the GPs. The LPs have no responsibility beyond the capital they commit nor control over the timing of the investments or distributions.
- Open-end funds: these can be entered and exited at a pre-determined time (monthly or quarterly) by an investor, but are often subject to redemption restrictions depending on the volume of liquidation requests relative to the net asset value of the fund.
- Closed-end funds: these have a fundraising period that lasts anywhere from 3 - 24 months; investors have a finite time in which to invest.

Real Estate Investment Profiles

Real estate can be separated into different categories, which differ in terms of investment profile, sector and market attractiveness:

Core - High quality assets with high levels of occupancy, located in the most desired locations. Core assets often have lower levels of leverage on the property and are held for long periods of time, due to the attractiveness of the predictable income. These assets rarely require meaningful development or improvements to the property, so much of the return is derived from current income, collected from rent. Core assets have a lower risk/return profile.

Core Plus - High quality assets in strong markets that likely require minor refreshes to increase occupancy and grow cash flow. Core Plus managers may utilize a slightly greater amount of leverage on assets, resulting in a return profile that is derived equally from current income and capital appreciation, which can enhance risk.

Value Add - These investments require redevelopment but have existing tenants and current rental income, which can offset some of the costs. The majority of return typically comes from capital appreciation, along with a supplemental current income component. Moderate leverage is utilized and there are typically moderate risk and reward dynamics.

Opportunistic - These are special situation investments or distressed properties that may include: halted construction, bankruptcy, ground-up development or heavy redevelopment. The majority of return is expected from capital appreciation; higher levels of leverage are used. This is the highest risk/reward profile within traditional private real estate investments.

Core
High quality asset
High levels of occupancy
Desired locations

Core Plus
High quality assets
Strong markets
Require refresh

Value Add
Require redevelopment
Existing tenants/rental income offset cost

Opportunistic
Special situations:
Halted construction
Bankruptcy
Ground up development

Opportunity Zone Funds
Tax advantaged incentives
Less attractive areas

Opportunity Zone Funds - A tax advantaged investment in private real estate, which came about as a part of the Tax Cuts and Jobs Act of 2017 which seeks to incentivize real estate development in less attractive markets (as defined by census reports 10 years ago). The projects must be ground-up development and held for a minimum of 10 years in order to maximize the tax incentive. Although investment in these type of strategies may not be new, the vehicle itself is new, and as such should be considered high risk.

Structure

Typically, private real estate investments are limited partnerships, where the General Partners (GPs) oversees the investment of the fund's assets and manages the day-to-day operations. LPs supply the capital and are considered a silent partner, seeking to benefit from the GPs skill.

Private real estate funds are generally closed-end investment vehicles with a life of at least 10 years and often have up to (3) one-year extensions. The extension period provides the GPs with flexibility around the exit timing of investments. For context, consider being forced to exit a private real estate investment in 2008 during the height of the global financial crisis, versus waiting until 2011 when the market had more time to recover.

Limited Partnership Phases

COMMITMENT
GPs raise capital from investors and LPs make capital commitments to the fund.

INVESTMENT
GPs start drawing on investor capital commitments to invest in real estate deals and implement their strategy.

HARVEST
Income is collected and distributed. Capital improvements are made to properties.

DISTRIBUTION & EXIT
GPs can exit early investments and either reinvest into new properties or distribute capital to investors (LPs).

COMMITMENT

Once an LP is invested, there are different stages to the investment. The initial phase is known as the "commitment phase", where the GPs raise capital from investors and LPs make capital commitments to the fund. The funds raised during this time period ultimately dictate how much the GPs will have available to invest.

INVESTMENT

The investment period commences once the GPs start drawing on investor capital commitments to invest in real estate deals and implement their strategy. During the investment phase, the GPs call the LP's capital through a "capital call". A capital call indicates the GPs have found a worthy investment and agreed to the terms with a seller and are now ready to fund their portion of the investment. These calls are generally a fraction of the overall commitment, until the capital is fully called. The investment period generally happens over a period of 1-3 years, depending on how quickly attractive opportunities can be identified and terms negotiated.

HARVEST

Once all the capital has been called and deployed into underlying investments, the fund enters the "harvest phase". This phase often overlaps with the investment phase, in particular with the investments made early on. The focus now is on growing the fund's investments and ultimately seeking to exit at a profit. During this time, the GPs may exit early investments and reinvest the proceeds into new portfolio companies or return capital to investors in the form of a distribution. Private real estate investors only receive their capital back when the GPs decide to make a distribution.

DISTRIBUTIONS AND EXIT

Generally, all income received from rent collection flows through to LPs. Also when a property is sold, the recognized gain/loss flows through from a tax perspective. All tax related transactions are captured and reported to LP's via a K1. An exit transaction is the primary driver to recognize value creation.

Private real estate funds can exit their properties in several ways:

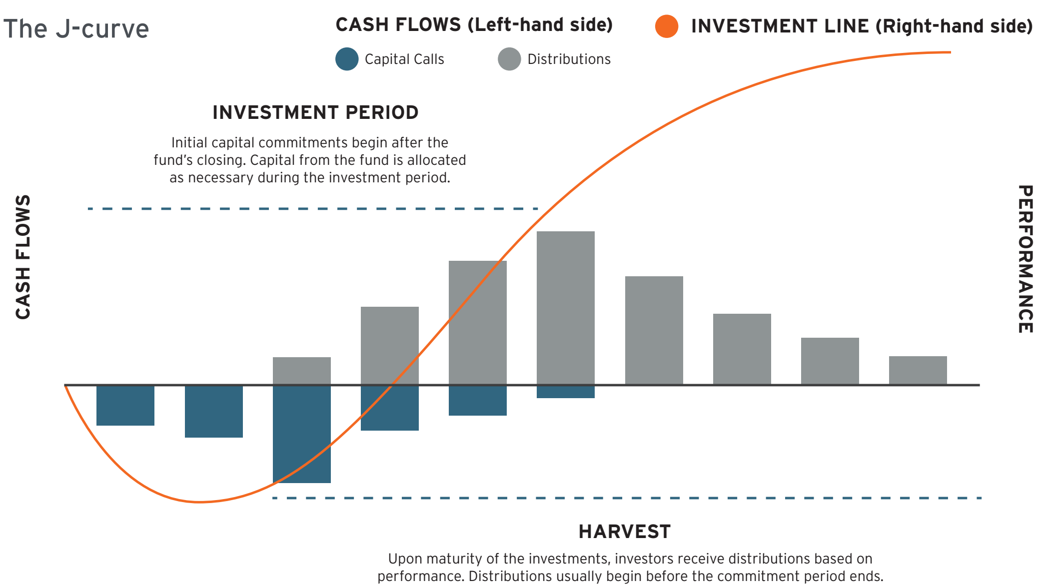
- Recapitalize/refinance the property following development and lease-up
- Sell the asset, properties can be sold individually or as a full or partial portfolio depending on the buyer
- Property owners may sell to another buyer of core property

J-Curve Effect

Investors will not have positive cash flows from the investment for several years, this is referred to as the J-curve. The J-Curve is generally a function of four things:

1. Real estate investments that produce current income from tenants can mitigate the J-Curve Effect. However if the real estate requires upfront investment this will lead to a typical J-Curve drag.
2. Management fees are paid without seeing a return on investment and can be charged on the entire committed capital which hasn't been put to work.
3. Often, to be conservative, portfolio holdings are held at cost for an extended period of time
4. Expenses associated by the real estate transactions are borne by the fund up front, leading to a drag in performance early on.

Fig. 1 | The J-curve



References
4. Mercer. For illustrative and educational purposes only

The J-curve effect is mostly unavoidable in the structure of private real estate investments and is accepted as a part of the return experience by long-term investors in the asset class. Successful investors in private real estate understand the need for patience with early reported returns that are not indicative of potential long-term success from the investments.

Considerations in Allocating to Private Real Estate

There are many sectors within private real estate that you may consider for diversification:

- Industrial
- Retail
- Multi-family residences
- Office
- Storage
- Medical office
- Senior housing
- Student housing
- Data centers

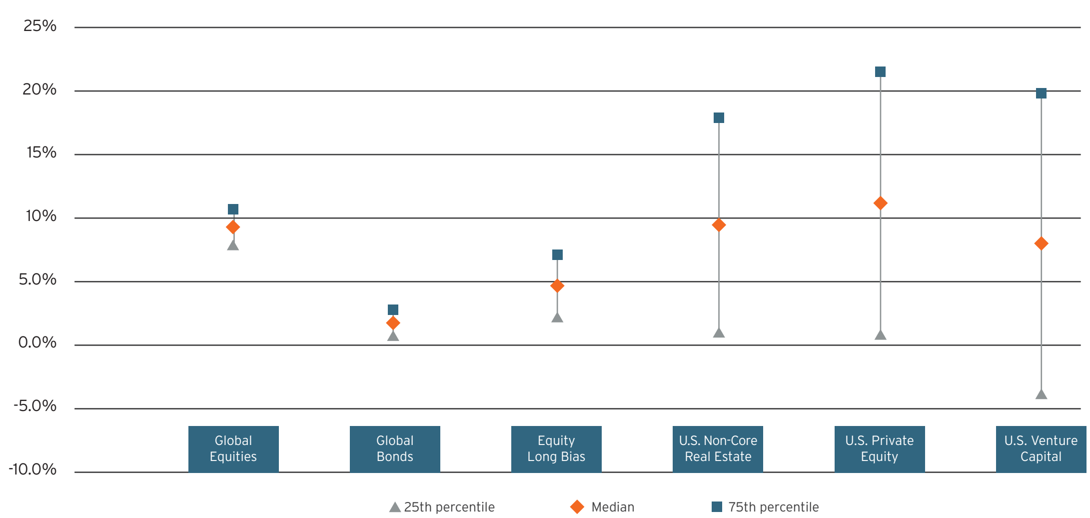
There are also different considerations in terms of properties:

- Location's attractiveness - population, barriers to entry
- Resiliency of the local market
- Diversification of geography
- Vintage year - consider vintage year diversification given long-term nature of these investments; this helps mitigate risks due to market cycles and timing of both entry and exit.

Importance of Manager Selection

The interquartile spread in private real estate is high, making informed manager selection paramount to successful investing.

Interquartile Spread by Asset Type



Sources: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management. Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. Manager dispersion is based on 2013 - 2018 annual returns for global equities, global bonds, U.S. core real estate and hedge funds. U.S. non-core real estate, U.S. private equity and U.S. venture capital are represented by the 5-year horizon internal rate of return (IRR). Data is as of December 31, 2018. Confidential | For Investment Professional and Qualified Investor Use Only.

*Past performance is no guarantee of future results

Noteworthy Risks of Private Real Estate

- Illiquidity
- Volatility in Private Markets
- Lack of Control
- Leverage

Evaluating Alternatives

What is important in evaluating alternatives to add to an individual's portfolio?

- Having a thorough and knowledgeable team that understands and can navigate investing in alternatives.
- Access to top-tier alternative investments.
- Lower and more attainable minimums for individual clients.
- Understanding how that investment is expected to perform over time and monitoring that performance.
- An understanding of the fee structure.
- Understanding the illiquid and long term commitment to the investment.

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