WINDROSE ADVISORS

REAL ESTATE INVESTING ACROSS CYCLES

INTRODUCTION

"Real estate cannot be lost or stolen, nor can it be carried away. Purchased with common sense, paid for in full, and managed with reasonable care, it is about the safest investment in the world."

– Franklin D. Roosevelt

There are plenty of arguments to be made over what is the 'safest' or 'best' investment in the world, but what is clear is that real estate is often an incredible wealth creator over time and is an important asset class within a diversified portfolio. Real estate offers stable income generation, value-creation upside, protection against inflation and beneficial tax treatment. Further, real estate is a tangible asset, with an intrinsic worth due to its physical properties. As real estate is something that can be seen and felt, many investors are drawn to this attribute rather than a security that evidences a financial claim.

Over the years, the investable universe for real estate has grown tremendously, both on the public and private side. Once viewed as an asset class more narrowly focused on apartments, offices, hotels and retail, the asset class now includes opportunities in data centers, cold storage, senior living, film studios, self-storage, student housing, amusement parks and many other niche opportunities, each with their own market dynamics.

Globally, real estate is now one of the largest asset classes available to investors, after fixed income and equities. LaSalle Investment Management estimates that the global institutional real estate investable universe totals $9.6 trillion, comprised of $5.1 trillion in privately held institutional properties and $4.5 trillion of properties owned by publicly traded real estate companies. The massive market opportunity is one reason institutional investors typically allocate an average of 10% of their portfolios to real estate and that the asset class continues to experience an acceleration of institutional capital.[1]

For the remainder of this white paper, we will focus exclusively on Windrose's approach to private real estate investing, both through fund structures and on a direct basis. Since the formation of Windrose, the bulk of our real estate investing is in the private markets, where we enjoy strong performance across vintages and types. Windrose also invests in public real estate, primarily through our Public Real Assets Sleeve, which is a vehicle designed to protect portfolios against inflation. Within this vehicle, we have exposure to REITS and other real estate-oriented companies, through long/short hedge fund structures.

Performance & Portfolio Protection

"Real estate is an imperishable asset, ever increasing in value. It is the most solid security that human ingenuity has devised. It is the basis of all security and about the only indestructible security."

-Russell Sage, American financier

The inclusion of private real estate in a diversified portfolio is predicated on low correlation to the public markets and strong historical performance. Over the past two decades, private real estate performance correlated only to 15-19% of S&P 500 returns, underscoring the diversification benefits.[2] In terms of long-term performance, private real estate has returned 10.5% over the past 10 years and nearly 7% over a twenty-year period, typically much of that total return coming from income. Top quartile IRR was 18.04% and 22.20% for the 10- and 20-year period, respectively.[3] Additionally, private real estate is one of the few asset classes that can protect

[1] Federal Reserve Board of Governors, The Conference Board and Pensions & Investments.

[2] NCREIF: NAREIT 20 years ending December 31, 2017.

[3] Cambridge Associates. Q2 2020 Real Estate Index and Benchmark Statistics.

against inflation, as increasing prices can be passed along to the end user in the form of increased rents.

Windrose takes an opportunistic approach to private real estate. We build a somewhat concentrated portfolio that is diversified across real estate sub-sectors and geographies and take concentrated bets on individual real estate assets that offer attractive risk/return characteristics. We focus on strategies that can result in significant value-creation at the property level, meaning we prefer value-add and development approaches, where through physical and operational improvements cash flows can be accelerated and overall value increased.

The managers we partner with are truly exceptional and each brings a unique 'secret sauce' and/or area of expertise to our portfolio, whether that be related to property type, geography, or operational capabilities. The common denominator between all is a focus on intrinsic value/replacement value, supply and demand imbalances, high barrier-to-entry markets, and the opportunity to improve operations and/or asset quality. Many of these managers are also vertically integrated, which means they are structured to handle many or all of the aspects of managing a commercial real estate investment in-house including managing investments, acquisitions, property management, and construction and development. Vertical integration in real estate investing reduces costs, driving economies of scale and mitigating risk.

Within our portfolio, we focus primarily on North America. The opportunity set is very robust and we can thoroughly conduct due diligence on managers and use our networks to uncover attractive opportunities. Within direct investments, we lean towards New England and the greater Boston metro area, as it is a market we know well and enjoy very strong relationships. On a sector basis, we favor multi-family (apartments) and senior living market segments along with industrial, life science office, hospitality, and mixed-use assets. More recently, we focused our attention on industrial/logistics-oriented properties, single family homes and hotels, which we expand on below.

Windrose's opportunistic approach resulted in strong performance to date, both across fund investments and direct deals. Our manager selection and ability to diligence individual deals is a differentiator. Across realized direct deals, Windrose generated a 1.6x net multiple and 23.0% net IRR[4,6]. Across realized and unrealized fund and direct investments, Windrose generated a 1.4x net multiple and 15.4% net IRR[5,6].

CYCLICALITY & FLEXIBILITY

"Before you start trying to work out which direction the property market is headed, you should be aware that there are markets within markets."

-Paul Clitheroe, Australian financier

"A funny thing happens in real estate. When it comes back, it comes back up like gangbusters."

-Barbara Corcoran

Real estate is cyclical and it is very difficult to predict the timing of a cycle. To counteract cyclicality, we built a portfolio and partnered with managers that can invest through all phases of a cycle. This is predicated on partnering with managers that can identify high-conviction themes within their areas of expertise while evaluating special situations when they present themselves, focusing on intrinsic value, developing value creation plans to accelerate and improve cash flows, how to ultimately exit investments even before committing capital. Investing through a market cycle also means executing investments across the capital structure, both equity and debt, depending on what is

Figure I: Real Estate Market Cyclicality

Source: Centerbridge

4 As of 9/30/20. Based on realized exits of 3 direct deals.
5 As of 9/30/20. Based on 25 fund and direct investments.
6 Performance is net of manager fees, gross of Windrose Advisory fees.

the best risk-adjusted investment. For example, when lenders aggressively provide capital at low interest rates and with limited financial covenants, it may be compelling to invest in the equity of properties. Conversely, when lenders are overly cautious and wish to sell at low prices (high rates of return to the buyer), it may be compelling to invest in credit (e.g. senior debt).

Examples of shifting opportunities across the capital structure were on display over 2020, as the global economy was significantly impacted by Covid-19. In March 2020, when market volatility spiked, real estate loans in the credit markets became attractively priced and an opportunity arose to invest at deep discounts to intrinsic value, an opportunity many of our managers pounced on. As the market dynamics evolve over the next several years, there may be opportunities to buy real estate properties through the equity or debt-for-control situations, as there may be a forthcoming distressed opportunity set in the form of rescue financing, restructuring, and deleveraging capital, to name a few.

ON-THE-GROUND PRESENCE

“Think ahead. Don’t let day-to-day operations drive out planning.”

-Donald Rumsfeld

“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.”

-Warren Buffett

Real estate is operationally intensive and managerial decisions can greatly affect returns. While it is possible to ‘win’ on the buy through informational asymmetry or fortuitous timing, it is just as important is a strong operational focus. Questions such as: What rents should be charged? What concessions should be given? How are leases structured? What physical improvements should be made? How are resources apportioned across a portfolio? Along with market forces, answers to such operational-focused questions can determine whether a desired return will be earned within a reasonable timeframe.

Due to this intensive nature of owning and operating real estate, we typically invest with managers that are operators, as opposed to solely providers of capital. Strong operators benefit from on-the-ground intelligence and market knowledge. They can apply consistent standards across portfolio capital improvements, development projects, leasing programs, property management, and reporting procedures. Importantly, they also have operational pattern recognition and can make changes with conviction, when necessary.

Real estate owners benefited from advancements in technology in recent years that improved operational capabilities. As early adopters, our managers incorporated these new tools into their ‘play books’ as differentiators. Most notably, the “internet of things” (IoT) allows operators to track trends, monitor a property in real time, and improve the management of properties. Owners can use data gathered from technology platforms to answer questions such as: Where are the areas with the highest foot traffic at different times of the day? What spaces are used the most? What is the most efficient temperature during the day vs. at night?

COVID IMPACT & OPPORTUNITIES

“In investing, what is comfortable is rarely profitable.”

-Robert Arnott

The Covid-19 crisis is unlike any we have seen in modern history. While the last recession was brought on by a financial crisis, the current downturn was sparked by a health crisis. The impact to real estate from the Covid-19 pandemic continues to unfold and the overall magnitude may not be known for years. The shutdown of public life led to an outsized impact on certain areas of the commercial real estate market and the effects of the sharp deterioration in the labor market could have further impact.

While the institutional real estate market was generally much healthier (less levered and benefiting from stronger underwriting) coming into 2020 than going into the Great financial Crisis (GFC), a decade of ultra-low interest rates allowed financial risk to accumulate, which the pandemic is now laying bare. Many market observers expect defaults in commercial real estate caused by the pandemic to be worse than what happened during and after the 2007-2009 recession. The unknown is if the pandemic will force a fundamental reconsideration of how people work, travel, shop and live – shifts that could potentially result in significant losses across commercial real estate.

The silver lining is that the current and future challenges to real estate will not apply to every kind of property. Real estate is a vast asset class and each property type has different physical characteristics and market dynamics. For example, fundamentals continue to deteriorate across retail, hotel, and downtown office space. While on the other hand, some real estate sectors are unaffected or even benefit, such as warehouse and logistics, single family homes and self-storage.

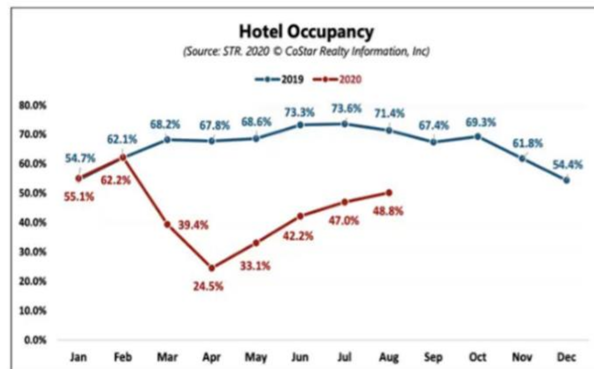
As with any extreme event that can shift markets, much depends on the direction and severity of the virus over the next six months and the effectiveness of vaccines. Distress will likely continue and increase within some real estate sectors. Lenders, for the most part, were initially happy to grant debt forbearances and wait out the pandemic. As the pandemic drags on and forbearance periods expire, more lenders will go after properties, demanding additional capital in exchange for extended relief or offloading their exposure to opportunistic buyers.

This unraveling typically takes years to fully play out, as was experienced in the GFC, so distress will continue to mount across real estate sectors and assets that are most exposed to a post-Covid world. Below are a few of the areas within real estate that we are paying close attention to and actively seeking opportunities in for investment across the capital structure.

HOSPITALITY

The hospitality industry is the most impacted by the Covid-19 pandemic. The impact is greater than 9/11 and the financial crisis combined. The impact was swift as hotel revenues fell 80% in less than 30 days in early Spring 2020.[7] Hotel occupancy rates across the U.S. dropped to 33%, on average, for the three months ended June 30th, while many hotels experienced occupancy levels in the single and low double digits depending on their location and physical layout. More recent data as of Q3 2020 shows that the sector remains pressured by the pandemic as national hotel occupancy decreased 36.8% YOY while RevPar (industry standard metric for calculating revenue per available room) fell by 54.4% YOY.[8] Full year 2020 revenues are expected to be down 50% or greater from 2019.[9]

Figure 2: Hotel Occupancy



Source: STR 2020. CoStar Realty.

The drop in demand is already causing severe financial stress among hotel owners and the velocity of the downturn evaporated pre-crisis liquidity. As is stands, nearly 20% of all hotel loans originated by commercial real estate lenders are now delinquent and Fitch, a credit ratings agency, projects that 19% of loans will default. It is likely that distress will increase as Paycheck Protection Program (PPP) money evaporates, Covid-19 levels rise and lenders pressure asset owners to fulfill their financial obligations. This continued distress has made it difficult for market participants to determine applicable discounts to pre-Covid levels, resulting in anemic transaction activity over Q2 and Q3 of 2020 with wide bid/ask spreads.

Hotels most negatively impacted tend to be located in urban markets, particularly group and meeting/convention-oriented properties or those reliant on business travelers; it is likely that they will take the longest to recover. Drive-to resort markets are expected to perform better among the hotel sector given their reliance on leisure demand and travelers' reluctance to fly.

Due to the extreme distress, there will be opportunities within hospitality, both through debt and equity investments. Particular areas of interest include: 1) Hotels located in drive to leisure markets that are typically outside of major urban city centers and have low dependence on large group business, 2) Limited-service hotels in suburban markets, 3) High barrier-to-entry luxury hotels that have higher operational complexity and information asymmetry.

[7] Schulte Hospitality Group, May 2020.
[8] CBRE 2021 U.S. Real Estate Market Outlook.
[9] U.S. Hotel Forecast Update May 2020.

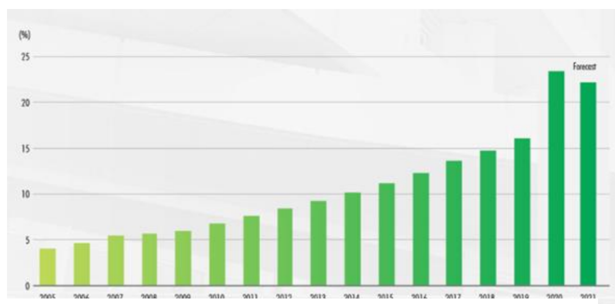
In light of the compelling opportunity set within hospitality, Windrose made a direct investment in Q3 2020, alongside a trusted partner in a value-add hotel asset located in a high-barrier-to-entry leisure market in the Western U.S. The hotel was acquired at a 50% discount to replacement cost, has multiple levers for value creation, and has physical characteristics that are conducive to a post-Covid world. Further, the investment consists of preferred equity and common equity, which we believe offers both risk mitigation and upside potential, as well as a current income component.

INDUSTRIAL & LOGISTICS

The recent pandemic pulled forward the acceleration of e-commerce and brought to light issues around supply chain restructuring and onshore manufacturing. These key trends are increasing demand for warehouses and distribution facilities. Case in point, Amazon opened 100 warehouses nationwide in September 2020 alone, in preparation for the holiday shopping season. Due to this shifting consumer behavior toward the convenience of e-commerce, JLL (a real estate service company), estimates the industrial market could require another one billion square feet by 2025 to meet demand.

The strong performance of industrial real estate is not new but has been highlighted by the pandemic. According to CBRE, Q3 of 2020 marked the 42nd consecutive quarter of positive net absorption for U.S. industrial real estate.[10] Fueled by e-commerce growth, annual industrial absorption will total more than 333 million square feet by 2022, leading to annual rent growth of 5.7%, which is more than triple the previously forecasted demand by CBRE. This exceptional performance in the sector drove cap rates down to 6%, on average, and below 4% for Class-A assets in the top markets.

Figure 3: E-commerce sales penetration
(% of total retail sales)



Source: CBRE Research 2021. U.S. Real Estate Market Research.

While industrial real estate is the best performing real estate type over the past decade and the growth prospects are attractive, the sector is not cheap, as reflected in falling cap rates. Further, many institutional investors remain under-allocated to the sector and are plowing capital into the space to reach allocation targets and stabilize real estate portfolios impacted by other sectors, such as hospitality, office and traditional retail.

Clearly, this opportunity, along with strong investor interest, will continue to be driven by trends in e-commerce and supply chain management. The market is still highly fragmented with 70% of real estate assets held by private owners and users[11], and the top five owners representing only 8% of the total 16.8 billion square feet[12]. As always with real estate, location is key and especially for industrial where access to highways, intermodal rail, and air cargo is critical, alongside proximity to population density and consumption.

Areas of particular interest to Windrose within industrial include: 1) Value-add acquisitions and repositioning with all-in basis below replacement cost 2) Cold-storage facilities to expedite distribution 3) Micro-fulfillment centers with highly automated order-picking capabilities, and 4) Opportunities to convert retail or office properties into single or multi-tenant industrial facilities near high-population centers.

SINGLE FAMILY HOUSING (SFH)

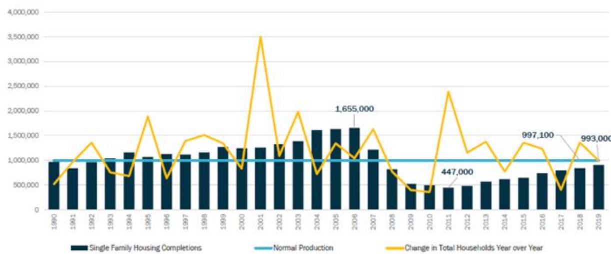
The pandemic sent urban Americans rushing to the suburbs in search of a lawn, room for home offices and a safe distance from neighbors. This hyper-awareness about living environment and a shift to a work-from home model removed a longstanding barrier to living in more suburban areas and is driving demand for single-family living. In addition, low mortgage rates helped propel this ‘migration to the suburbs’, as 30-year fixed mortgages dropped below 3% in July, and by November had dropped even further, to below 2.8%. Reflecting this demand, the S&P CoreLogic Case-Shiller national home price index, which tracks changes in the total value

[10] Newmark Knight Frank
[11] CoStar Analytics, August 2020
[12] Real Capital Analytics, August 2020).

of single-family homes in the U.S., is up 6.8% YTD as of Dec 2, 2020.

The flight to suburbia for single family homes, whether for-sale or for-rent, is reversing a trend towards urbanization that gained momentum in the decade before the pandemic and resulted in a multi-year single family housing production deficit (in addition to increasing labor and hard material costs) that left the market severely undersupplied to accommodate the current and expanding demand. Housing starts have begun to increase, but still remain well below long-term averages. Excess production from the last cycle has now been absorbed.

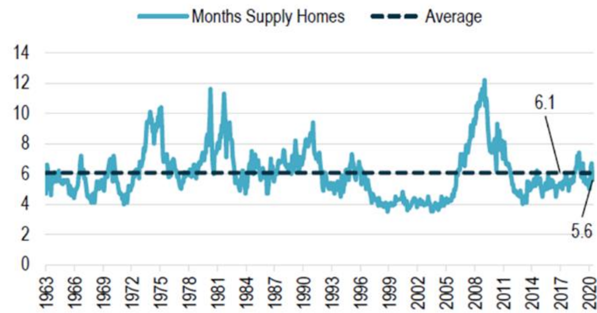
Figure 4: National Production Deficit



Source: Westport Capital & U.S. Census Bureau

Compounding this shortage of housing stock is that over 80 million ‘Millennials’ are reaching their prime first-time home buying years and are already driving a sharp increase in home ownership. Areas that stand to benefit the most from these trends are the lower-cost Sun Belt markets, a region in the US stretching from the southeast to the southwest, where job growth, population growth and affordability continue to attract households from higher-cost regions.

Figure 5: Inventory of Residential Homes is Tight



Source: Westport Capital & U.S. Dept of Housing & Urban Development, May 2020

The opportunity looks attractive in both for-sale and for-rent single family housing. In the near term, there may be opportunities to acquire distressed residential projects where developers and builder are undercapitalized or otherwise unprepared to deal with the inevitable disruption from the current crisis. On a longer-term basis, opportunities may exist in: 1) horizontal master plan community and subdivision developments, 2) joint ventures with homebuilders to participate in both the horizontal and vertical home development, and 3) building, leasing and stabilizing single-family-for rent communities.

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