HODES WEILL
& ASSOCIATES

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Hodes Weill's 2020 Market Commentary

Roaring into the 20's

As we welcome in a New Year, we are back once again with our Annual Market Commentary — Top Ten Market Observations. 2020 also marks the beginning of a new decade – and our second decade in business at Hodes Weill & Associates.

As we prepare to go to print on our 11th Annual Market Commentary, we are struck by the remarkable sameness of the message from the past several years. Once again, despite conflicting market signals, geopolitical tensions, and yet another year of increasing valuations, global investors are staying the course and continuing to deploy substantial volumes of capital into real estate assets. Moreover, investor sentiment for the asset class has been trending upward after several years of declines, as reported in our 2019 Institutional Real Estate Allocations Monitor. Capital continues to target a broad range of asset types, geographies, risk strategies, and investment structures. The past year saw large inflows of capital into real estate private funds, and as in years past, much of this new fund capital was committed to a handful of the largest real estate fund managers. There is still caution in the air, as we wait for a shoe to drop that will signal the end of one of the longest economic and real estate market expansions in history. That said, while we are skeptical, we note that we are beginning to hear from industry experts why this economic cycle may last longer, with reference to Australia's 27 straight years of positive economic growth.[1]

"Yeah, I've been lucky. My business is pretty darned recession-proof."
CartoonStock.com

During the past year, investors showed continued enthusiasm for new asset types that benefit from either strong demographic trends or the real estate requirements of the "new economy." Alternative real estate categories are quickly becoming a regular part of the "basic food groups" though where and how investors invest in these new sectors vary widely. Multifamily and logistics assets continue to command the strongest capital inflows, consistent with investors' focus on predictable and sustainable cash flows. Multifamily returned to the institutional "buy list" as concerns about excess supply of Class A CBD product abated with strong absorption and decent rent growth. As institutional interest tends to cycle, we wonder what will be the next strategy or sector to return to favor. It is notable that PREA's recently published 2020 Investment Intentions Survey stated that "office is the most popular sector for 2020 investment, followed by residential and industrial."[2] Given macro trends, investors will remain reluctant to pursue hotel and retail assets generally, though many opportunistic investors are finding interesting opportunities in these sectors. The flow of capital into real estate debt continues unabated, and the lending markets are open and competitive.

So, what has changed in the past year? With a further decline in overall returns, the frictional costs of investing, especially cross-border, are having a greater impact on investment decisions. However, with the easing of

[1] Australian Trade and Investment Commission, "Australia Holds World Record for Longest Period of Growth Among Developed Economies," 11/28/2018.
[2] PREA 2020 Investment Intentions Survey.

some geopolitical uncertainty (e.g., Brexit, China-US trade tensions), investors are returning to markets that they had previously avoided given the asymmetric nature of the risks. On the other hand, markets that had been considered safe and open for business (e.g., Hong Kong), have now been sidelined, at least temporarily, pending more clarity on the resolution of their non-real estate market risks, not to mention the impact of the novel coronavirus, now declared as a global health emergency. Given the introduction of residential rent controls in many US markets, investors are also re-thinking their strategies in the US multifamily sector, though this is unlikely to materially reverse the flow of capital. However, the past year also saw the local backlash that drove Amazon out of Long Island City, so investors are taking a closer look at local "populist" considerations when making investment decisions. ESG moved higher on the investor checklist in 2019, as the demands of tenants and owners to focus on sustainable cities and assets evolved from "nice to have" to "have to have." Investors, lenders, insurers, and rating agencies are showing a greater interest in this cause, and we expect that the momentum of 2019 will pick up speed in 2020.

And finally, 2019 was the year when WeWork ceased to defy gravity; the capital markets were unforgiving as the reality of WeWork's management approach and business model became clearer after everyone read the fine print in the S-11 prospectus. However, the revaluation of WeWork as a real estate company, rather than a tech company, does not portend the end of collaborative real estate strategies (co-working, co-living, flexible leases, etc.). Clearly, the grounding of WeWork doesn't imply the end of innovation in the real estate sector driven by new ideas, 21st century work requirements, and evolving technologies. Despite the potential for dislocation that could result from WeWork's exit from many markets where it had been a major driver of leasing activity, many also took comfort that the basic laws of the real estate market - such as supply and demand and the balancing of assets and liabilities - seemed to rule once again.

We are pleased to present for your consideration our Ten Market Observations – combining our views of the year just passed with our outlook for the year ahead. We hope you find these observations interesting and helpful as you consider your future investing strategies in our dynamic global market. And as always, we welcome your feedback and thank you all for your support and friendship. We look forward to speaking with you over the course of 2020.

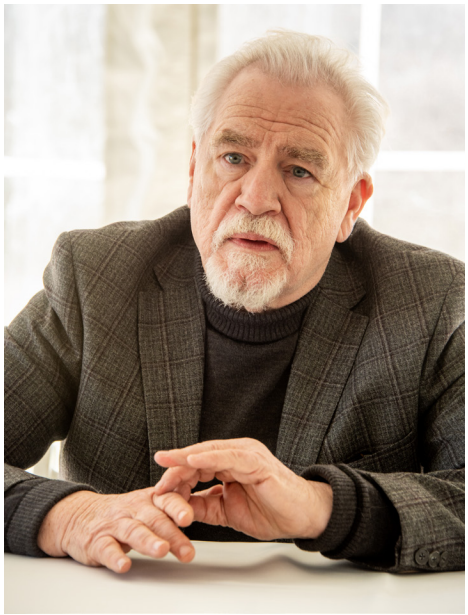
Measuring Risk in the Age of the 1,000-year flood

As urbanization trends and population growth persist, greater strain is being placed on global infrastructure systems. The UN estimates that nearly two-thirds of the world's population will live in urban areas in 2040, a significant increase from less than half just two decades ago.[3] We are already observing palpable environmental and infrastructure related complications, though to some degree the cause remains heavily contested. While many cities are preemptively modernizing their antiquated infrastructure systems and addressing threats posed by climate change, others continue to overlook or defer action, thereby jeopardizing commerce, quality of life, and their real estate markets. The mounting frequency of infrastructure failures and natural disasters suggests that historical data may no longer be indicative of the future. Real estate investment managers

[3] United Nations, "World Urbanization Prospects."

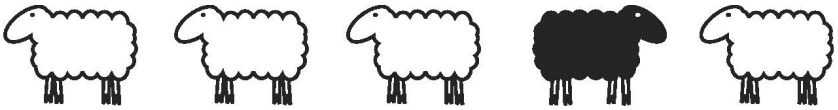
are in the initial phase of determining how (and within what timeframe) to incorporate these risks and potential costs into their underwriting and portfolio management strategies. Fundamentally, real estate investments can be impacted in one of two ways: (i) reduced or lack of liquidity upon exit; and (ii) declining cash flows (lower tenant demand and/or higher municipal taxes, insurance premiums, capital expenditures, financing costs, etc.). Some investment managers are also looking beyond the asset and evaluating a municipality's foresight, authority, and financial capacity to fund infrastructure improvements and climate change resiliency strategies. Bond markets are taking notice of these considerations, real estate and its debt are not somehow immune. Although investors have yet to broadly voice their hesitation to invest in otherwise attractive markets on the basis of infrastructure or climate change concerns alone, the question remains how long this may continue. Most global gateway markets are situated in coastal regions and rely on outdated infrastructure systems. Major institutional investors are requiring their managers to take this very seriously, and it will be part of the basis to judge performance. We foresee more collaboration among all stakeholders to not only help increase understanding of the issues, but also to develop common standards, to share insights regarding available measurement tools, and to promote best practices.

Succession Planning



For fans of HBO's "Succession", Logan Roy has taught us that it's complicated for companies to plan for the future. This is no different in the real estate investment management industry itself, which came of age approximately 40 years ago, led by some of the sharpest real estate and financial minds of our time. Many of these industry leaders have built firms with meaningful enterprise value rooted in their management expertise. As these founders seek to transition from day-to-day management and properly align their next generation of investment professionals, they are evaluating strategic options for their platforms. Increasingly, these options include the possibility to sell a strategic stake in their businesses. These firms are trying to avoid the risk of losing key professionals that have earned the right to be economic stakeholders if they do not further distribute their ownership interest and firm equity. These transactions are often necessary catalysts to transition ownership to the next generation of partners. While the monetization of some of a founder's economic interest in his/her firm may not always be well received by its investors, clients generally understand and are increasingly focused on the need for succession. This comes into focus when, for example, a manager is raising its next 10-year fund. This has resulted in a sharp increase in the volume of strategic transactions over the last three years, and we expect that this trend will continue over the coming years. But even when identifying the right buyer and properly incentivizing the next generation, navigating the post-sale business can be disruptive. Groups that get ahead of the planning are likely to achieve better outcomes given the lead time required to find the right strategic partner (or stake buyer) for the business and the typical lock-ups required of founders ahead of their eventual exit.

Dare to be Different



It is no secret that institutional investors have been focused on "doing more with fewer" investment managers over the past several years, creating a dynamic of "haves and have-nots" in the private real estate funds market. Two recent statistics jump off the page that highlight this point: 1) there are **922** private closed-end real estate funds currently raising capital, and 2) **11** private real estate funds accounted for ~45% of total funds with final closings in 2019.[4] It's clearly a crowded market and it's a safe bet that a significant number of the 922 funds currently in market won't reach their target sizes or possibly raise any capital at all. So, what separates the winners from the losers? Investment managers need to demonstrate a distinct differentiation (their "secret sauce") in their investment strategy from the broader market, as well as from the investment strategies of mega-fund managers. That being said, it is one thing to have a differentiated strategy and another to be able to distill it into an easily communicated message. In order to do so, it is critical to study and understand the broader market – what is your peer group among the 922, and what sets your investment strategy apart? Understanding the attribution of your returns is a good way to demonstrate your alpha. This is challenging, to say the least. Managers that can capture the attention of institutional investors by differentiating themselves as clearly and concisely as possible will have the best chance for success on the capital raising trail.

Here Comes the Sun

With the main uncertainty of Brexit behind us - the UK left the EU on January 31 - we have seen early signs that some investors who have been on the side lines, in some cases for years, are taking tentative steps to re-enter the UK market. By no means is the uncertainty completely behind us. In fact, there are new concerns over a hard Brexit after the Conservative Party added an amendment to the withdrawal bill outlawing an extension to the trade negotiations beyond December 31, 2020. This caused the UK equity market and the pound to give back the initial gains they made on the back of the Conservative election landslide. However, the 'Brexodus' (companies leaving London for European cities) that many feared has not happened, and there is a growing feeling that it never will. Many analysts predict that corporations will restart capital investment and growth plans, thereby leading to a bounce in near-term GDP growth. Meanwhile, London cap rates are offering a premium to their continental counterparts. Continental "Quantitative Easing" is also back which should drive continental yields even lower. Some intrepid investors are beginning to position themselves to take advantage of these market conditions on the assumption that London, which has traditionally traded at lower yields than its continental peers, will eventually revert to the mean and the pound will rise again.

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[4] Preqin (as of January 6, 2020).

Other "Returns" that Matter in the UK

With free next-day delivery, one-click payment methods, and smart assistants like Amazon Alexa, it has never been easier to purchase goods online. As of July 2019, e-commerce in the UK accounted for 22.0% of all retail sales, and this figure is expected to grow to 33.8% by 2024 and to 53% by 2028.[5,6]

Free returns, a service now offered by e-retailers trying to stay ahead of the customer service curve, has led to a huge uptick in e-commerce sales volumes (though at the expense of operating margins).

As a result, consumers are buying more and simply returning what they don't want. While typically 5-10% of in-store Christmas sales are returned, up to 50% of 2019 online Christmas purchases will be sent back to retailers,[7] with 75% of returned goods being clothes.[8] It is estimated that e-commerce returns have grown 95% over the past 5 years and by 2020 this trend is set to cost global businesses as much as $550 billion.[9] Forecasts for year-end 2019 showed that the UK has the world's second highest percentage of e-commerce sales relative to total retail sales (22%). Though slightly behind China (25%), the UK's online retail presence far exceeds that of Germany (9%), and the US (11%), thus making it the Western nation most vulnerable to a reverse logistics surge.[10] What does this mean for logistics real estate?

No longer are industrial occupiers thinking only in terms of first, middle, and last-mile, but reverse logistics has become a critical phase in the supply chain "circle of life". According to Optoro, a reverse logistics supply chain requires approximately 15% to 20% more warehouse space, and second-generation space with lower ceiling heights is preferred over modern, Class A space. These goods re-entering industrial assets are highly differentiated, higher-touch, processed slower, and cannot be stacked as easily on high racks.[11] In a UK industrial market that is already underpinned by solid fundamentals and rapid growth, the rise of reverse logistics is set to create further opportunities (and challenges) for retailers, logistics owners and operators alike.

Even Millennials Need Privacy

Today, roughly 70% of companies have some form of an open floor plan.[12] Advocates argue that it promotes an environment of collaboration, transparency, and productivity. The concept is not new – Frank Lloyd Wright is often credited as the first architect of the optimal open floor plan when he set out to design offices that would break down the social walls that divided people in the early 20th century.

Over the past few years, we have witnessed a strong resurgence of the open floor plan concept as companies try to attract Millennial and Gen Z employees who are demanding inclusive and flexible workspaces. A key benefit is that open floor plans can reduce a company's real estate footprint and drive down overhead costs. In fact, the

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[5] McKinsey Digital, "China Digital Consumer Trends 2019," 9/1/2019.
[6] Ecommerce News Europe, "Ecommerce UK accounts for 53% of retail sales by 2028," 7/10/2019.
[7] BBC News, "Christmas gift returns set to hit postal system," 1/2/2020.
[8] Independent, "Why your unwanted Christmas gifts are tricking the economy," 1/4/2019.
[9] Payments Journal, "What Country Has the Highest Online Shopping Return Rate,"2/13/2019.
[10] McKinsey Digital, "China Digital Consumer Trends 2019," 9/1/2019.
[11] CBRE, "Reverse Logistics, Stress in an Era of Free Returns," 12/19/2020.
[12] SHRM, "Fine-Tuning the Open Office," 6/7/2019.
[13] Cushman & Wakefield, "Why Space Matters: Density," 6/12/2018.

office market, at least in the US, has been on a 20-year densification march, contracting the space allocated to each employee virtually every year.[13]

However, the novelty is beginning to wear thin, and a number of studies have found that an open floor plan actually *decreases* productivity, limits collaboration, and stifles morale. A recent study by Harvard Business School found that open floor plans decreased face-to-face interactions by 70% and increased employee usage of electronic forms of communication, such as email and messenger systems.[14] Many employees comment that the lack of privacy and proximity to others limit their comfort with sharing opinions or new ideas. Of course, open floor plans are often noisy and full of distractions, making it difficult to concentrate and accomplish daily work. As companies continue to notice these shortcomings, we may just see employers shift back to more traditional floorplans, and in turn, demanding more office space.

Bricks-and-Mortar Still Relevant (in certain types) of Retail

In spite of unemployment hitting an all-time low in the US, total retail sales are projected to dampen slightly in 2020 as consumers face the uncertainties of an election year. Online sales will remain the most insulated in a market slowdown, but we also expect that *certain types* of physical retail will remain strong. We are seeing a return to brick-and-mortar stores given the Millennial and the Gen Z populations' preference for experience-based shopping. These consumers also want the ability to see/touch/feel goods they have researched online. They are able to begin the shopping experience online and then fulfill their purchases in person. This type of retail preference is driving the conversion of traditional shopping centers into mixed-use community centers providing access to services as well as retail goods. Real estate operators need to understand and cater to the spending patterns of the communities surrounding their assets to be well-positioned to create relevant and successful retail-oriented properties.

Seoul Searching for Income

Korean investors were the largest source of outbound capital emerging from Asia in 2019. We anticipate this trend will continue given swelling liquidity in institutional coffers and limited domestic investment options due to poorly performing equity and bond markets at home. The ramp up of acquisitions of core assets in Europe and syndicated debt investments in the US can largely be attributed to the search for yield to plug a fixed income hole. As we have seen with other institutions around the world, allocations to real estate are growing as an alternative to fixed income in this protracted low rate environment. Korean activities are nevertheless notable for how far and wide institutions have gone for income, notwithstanding concerns that they may be overpaying

[14] Bernstein ES, Turban S. 2018 The impact of the 'open' workspace on human collaboration. Phil. Trans. R. Soc. B 373: 20170239. http://dx.doi.org/10.1098/rstb.2017.0239.

for assets, investing in less liquid markets, and potentially over-extending themselves given limited resources.

We expect much of the same in 2020, as Korean institutions solve for ways to earn higher cash distributions. In fact, outbound volumes may grow even further given changes in Korean domestic REIT regulations, which have already resulted in a number of European assets being repackaged and sold as domestic securities to both institutions and retail investors.

Hong Kong...a test of resiliency

Not surprisingly, we have seen institutional real estate transaction volumes in Hong Kong drop sharply since the protest movement began last summer. The coronavirus outbreak adds a new level of concern and anxiety over the market. However, we have not yet seen distressed selling, nor steep declines in capital values more generally. In the past, the Hong Kong property market has proven to be highly resilient in periods of turmoil, such as SARS and the GFC, in each case rebounding strongly from months of low transaction volume. The stock market had in fact moved up off its lows of last August and managed to end last year up 10%, prior to the coronavirus led sell off that started in mid-January. While cautious and in no hurry to transact, many regional funds and institutional investors are following the real estate market closely and drawing on lessons from the past. We believe that most investors have concluded that in spite of the protest movement, Hong Kong's relevance as a gateway city and an important global capital market is not going away any time soon. A shift in sentiment could therefore occur quickly if the coronavirus is contained in the upcoming months and buyers sense that the economic and political environment have stabilized enough to warrant an entry point that compensates them for the current market uncertainty.

Profiting from Diversity

We are seeing attractive opportunities emerging in real estate that caters to the distinctive demands and preferences of growing ethnic communities in the US In particular, the Latino and Hispanic population, which currently stands at 17% of the total US population, is growing at the fastest rate. The Hispanic population is projected to double to over 100 million by 2050[15] (the Asian population, the second fastest growing cohort, represents 22% of population growth).[16] Real estate that is designed, tenanted and located in submarkets that embrace these communities offers an attractive value proposition. An increasing number of real estate investment managers are adopting strategies that address the supply-demand imbalances created by culturally distinctive preferences. For example, investors are re-tenanting retail centers to include ethnic grocers and other culturally relevant inline tenants, and senior housing operators are introducing more culturally relevant programming and designs into their communities.

These demographic trends are particularly important in multifamily and single-family housing as one in five Americans lives in a multigenerational household, up from a low of 12% in 1980. Additionally, while multigenerational living is growing among the majority of ethnic and racial groups, foreign-born Americans, Hispanics and Asians are more likely than other groups to live in a multigenerational household.[17] Developers and investors are already responding to this untapped demand by providing housing with enhanced flexibility that is designed to better accommodate these once non-traditional households' preferences and spatial needs. At the very least, these demographic trends reinforce the need for investment managers to dedicate resources to understanding and responding to America's enhanced diversity.

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[15] Pew Research Center, "With Fewer New Arrivals, Census lowers Hispanic Population Projections," 12/16/2014
[16] U.S. Census Bureau, "Projections of the Size and Composition of the U.S. Population: 2014 to 2060," 04/2015.
[17] Pew Reach Center, "A Record 64 Million Americans Live in Multigenerational Households, 4/5/2018.

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