White Paper

Era of Execution

CenterSquare INVESTMENT MANAGEMENT

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Introduction

Seismic change is often destructive, but it can also create awe-inspiring beauty. In Alaska, extreme natural forces with tremendous power, in the form of colliding tectonic plates, yielded majestic mountain ranges and an array of mesmerizing landscapes from glaciers and valleys to lakes and rivers. Situated along the Ring of Fire, one of the most geologically volatile regions in the world, Alaska can be a tumultuous and challenging place. Earthquakes, tsunamis and volcanoes all loom ominously as future risks to the environment. Yet it is also rich in potential resources and home to unparalleled natural beauty. Similarly, the ground-shaking disruption to the foundations of our capital markets in 2008 dramatically altered our own economic landscape. The magnitude of the initial shock decimated the investment universe as we knew it, and we continue to feel aftershocks today. The current economic environment remains fraught with uncertainty, and potential threats to stability persist. That said, opportunities to prosper exist for those with the vision and resources to navigate the rugged terrain. Even in the most turbulent of environments, potential growth and opportunity exist for those who thrive during times of change.

Much like the settlers who migrated to Alaska during the late 19th century in search of gold, those with the courage and capital to venture into the bleak real estate investment landscape following the the recession were able to harvest great value simply by acting when others could or would not. It was the Era of Acquisition, in which almost any real estate investment produced significant gains. Today, the easy-to-find opportunities have predominantly been mined. Investors must now seek to create value from the raw materials available in order to generate compelling returns. We have moved to an Era of Execution.

Alaskan Landscape

Highlights

- Since 2009, investors have flocked to stabilized core assets to the point that current yield is now overbought and total return assets are relatively underpriced.
- Due to the combination of a high cost basis and a lack of opportunity for increased yield, stabilized core assets carry greater risk than is currently perceived.
- In contrast, transitional value-add assets can be acquired at an attractive cost basis in today's market because they are perceived to carry greater risk. In reality, the competitive cost advantage created through redevelopment of these assets provides superior downside protection and less actual risk.
- Therefore, we believe that acquiring middle-market, transitional assets and executing a value-add strategy represents the best opportunity for creating value and reducing risk in the current environment.
- While 2008-2011 was largely an Era of Acquisition, in which lucrative opportunities were abundant for anyone with available capital, we are now in an Era of Execution, in which investors must create value and execute strategically to achieve attractive risk-adjusted returns.

All That Glitters Is Not Gold

Gold is precious due to its appearance and scarcity, and investors historically pay a premium for it in times of economic uncertainty. They view it as a store of value, a tangible asset to be accumulated during periods of distress, when its price often climbs substantially. Core property is the gold of the real estate investment universe. Since the Global Financial Crisis, investors have clamored for the perceived safety of its income streams and the comfort of owning the highest quality assets. However, these features are overbought today and the premium values attributed to these assets no longer offer compelling risk-adjusted returns. In fact, the significant fall in the price of gold since its peak in August 2011* could serve as a potential leading indicator for core real estate going forward.

**Source: Bloomberg*

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Rather than gold, carbon is our element of choice. Carbon is present in all known life forms and is the ultimate foundation upon which to create. It forms more compounds than any other element and can be converted into a variety of useful and valuable products. Value-add raw materials are the carbon of the real estate investment universe. In the presence of changing conditions, they can be restructured and their form altered. Carbon can be combined strategically with other elements and forged into something far more valuable such as diamond, one of the most durable and beautiful materials in the world. We believe the most compelling real estate investment opportunity that exists today involves finding the best carbon-like real estate, then applying the necessary strategic improvements to forge them into core-quality assets. These improved properties can then be sold at a significant profit to core investors willing to pay a premium for the finished product.

Value-Add Real Estate Investment

Value-add is a subset of private equity real estate investment that involves properties that exhibit financial or operational challenges, require physical improvement, and/or suffer from capital constraints. The strategy involves acquiring these assets at an attractive cost basis and executing a plan to resolve their deficiencies, stabilize their income streams and increase the overall value of the properties for disposition. Value-add real estate has historically fallen between core and opportunistic real estate strategies on the risk-return spectrum, representing a middle ground for investors with the real estate acumen and capital to take an active role in improving and monetizing their investments.

A value-add investment strategy involves the two primary goals of income growth and risk reduction. The successful execution of a business plan generates an increase in net operating income (NOI) through improved tenancy, higher rents as a result of targeted property enhancements, lower expenses or other improvements to the financial performance of the asset. In addition, asset-level risk is decreased by establishing durability in the property's income stream, resulting in lower risk to the owner and a lower potential cap rate upon disposition. "Cap rate" is a real estate industry term that defines the relationship between NOI and the value of an asset. Superior assets trade at lower cap rates (currently 5 to 6 percent) and inferior assets trade at higher cap rates (currently 8 to 10 percent). An investment process that focuses on both increasing NOI and reducing asset level risk (therefore decreasing the cap rate upon sale) results in a further increase in value of the asset at disposition and an improved total return on the investment.

Figure 1

Value-Add vs. Core

Core real estate, generally defined as high-quality assets in prime locations with stable in-place cash flows, has long been regarded as a safe, yield-producing investment option. The first real estate assets to see meaningful improvement following the Global Financial Crisis were core assets in major Central Business Districts, which began attracting foreign capital in 2009. This makes sense, as risk aversion led investors interested in real estate to those assets with the lowest perceived risk on the spectrum. Since 2009, investors have continued to flock to core real estate investments and values have shown continuous strength in response to the demand.

While core real estate continues to produce stable yields for owners, the cost to acquire that yield has grown significantly relative to other asset classes. In addition, as interest rates and/or inflation rise from current levels, these stable contractually fixed yields will become significantly less attractive and core owners will have limited options to increase yields. We believe that this combination of high cost basis and lack of opportunity for increased yield creates a very *real* risk of substantial capital loss in core real estate investments that exceeds the *perceived* risk for the asset class.

Investors traditionally perceive value-add real estate investments as having greater risk than core investments. However, experienced real estate investors can rectify issues such as income instability, operational difficulties, or physical deterioration in value-add investments. Importantly, underperforming transitional assets that serve as the raw materials in value-add strategies remain attractively priced, therefore assets burdened by such traits can be acquired at low cost bases and redeveloped into institutional-quality assets at significant discounts to their competitive set. The cost basis advantage that results provides for downside protection in the event of economic decline, while the opportunity to increase yield through improved NOI enhances value as markets improve. The low basis and yield growth potential in value-add assets make their *real* risks much lower than their *perceived* risks. This ability to invest with margin may create significant risk-adjusted returns.

We see an opportunity to arbitrage the mispriced perception of risk that currently exists between stabilized core assets and fundamental value-add raw materials. This pricing discrepancy exists largely because there is a prevalence of risk-averse investors in the marketplace willing to compete for the perceived safety of long-term leases at the cost of accepting lower yields on core assets. In fact, these core assets present potential exposure to an ultimate loss of capital, due to their lack of inflation protection, and an elevated cost basis, which burdens the assets in perpetuity. Opportunities abound to acquire fundamentally sound assets at highly attractive bases which many investors currently perceive as having challenges or risks for which they don't have the appetite. For those with the necessary capital and experience, these raw materials can ultimately be transformed into core quality properties with reduced risk profiles that many investors will line up to buy.

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Figure 2

Core Real Estate Real Risk > Perceived Risk	Value-Add Real Estate Perceived Risk > Real Risk
• Core real estate has lower perceived risk due to the supposed protection resulting from stability of cash flow and location • However, as interest rates and/or inflation rise from current low levels, core investments may be subject to risk of substantial capital loss due to high cost basis (i.e. real risk, without the ability to grow income)	• Transitional assets are perceived to be more risky due to their lack of income stability • However, the raw materials of a value-add strategy can be acquired and redeveloped into institutional assets at a significant discount to their competitive set • This ability to invest with margin may create significant risk-adjusted returns
High Basis + Low Yield = High Risk / Sell	Low Basis + High Yield = Low Risk / Buy

Why Value-Add Now?

Real estate values were significantly impacted by the Global Financial Crisis of 2008-2009 and, with the exception of cash-flowing institutional assets in gateway cities such as New York and Washington D.C., most real estate values have yet to fully recover. Many have compared the post-crisis real estate landscape to the market in the early 1990's following Black Monday. Indeed, one notable parallel is the similar delay in the recovery of private assets following the recovery of public market asset values. In the current cycle, the leading public market values have recovered while many private valuations have not. We can infer that we are in the midst of an optimal private market investment window, as seen in Figure 3.

Regulators' responses to the two market crises were markedly different. In the early 1990s, the formation of the Resolution Trust Corporation in response to the market crash forced distressed owners to liquidate real estate investments, thereby flushing assets into the market and allowing investors to purchase them almost immediately and at extremely low cost. The regulators' approach since the more recent Global Financial Crisis has created a very different scenario. Financial institutions were not forced to dispose of underperforming real estate assets during the downturn, and instead, were encouraged to "extend and pretend", limiting mark-to-market valuations and holding significant inventories of troubled assets. These assets have continued to deteriorate because distressed owners are unable to invest in them, but also unwilling to realize their loss in a sale. We believe that over the next several years, the physical needs of these properties will require significant new infusions of capital, prompting owners to finally dispose of them. Furthermore, rising interest rates will put additional pressure on owners to dispose of such assets. For an experienced value-add manager, this slow infusion of low cost value-add raw materials into the market presents a significant opportunity.

The relative pricing of core compared with value-add investments in the current market presents a further reason for purchasing transitional assets in the near term. The yield embedded in stabilized, yield-generating core assets has been overbought and many investors continue to overpay for it. The total return potential in value-add investing, however, has been significantly underbought since the crisis and subsequent recovery. A value-add investor can benefit from this potential by purchasing underpriced transitional assets, converting them into stable properties and selling into a yield-hungry core market. It is our thesis that creating or optimizing income streams purchased at a relatively low basis provides for greater margin and downside protection than purchasing existing current yield in today's unbalanced market. Particularly because the economic environment is dynamic, yield can be considered a fleeting aspect of an investment, while an attractive cost basis is a permanent component that will drive relative investment performance in perpetuity.

Figure 3

Extended Window of Opportunity

1987
Stock Market Crash
Black Monday

1989
Formation of Resolution Trust
Corporation

1992
Significant Risk-Adjusted Real Estate
Investment Opportunities

1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997

2007
Initial Capital
Markets Dislocation

2009
GFC Public
Market Low

2012
Significant Risk-Adjusted Real Estate
Investment Opportunities

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017

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Finding Value-Add Opportunities

When searching for value, we believe opportunities exist where capital is less plentiful. As investors focus heavily on key parameters such as primary markets and current income, the abundance of capital targeting the same pool of investments aggressively drives prices upward in the face of intense competition. The ability to source investments that provide a more compelling value proposition exists by targeting opportunities currently facing a scarcity of capital. These include transitional assets and properties in secondary markets (see Figure 4).

When evaluating value-add investments, it is prudent to consider the seller of a specific asset and seek to buy from unnatural or disinterested owners of real estate. These owners can include banks, special servicers and insurance companies, as well as municipal entities, religious organizations, hospital systems, or corporations that own their own buildings. However, even assets owned by experienced real estate investors can present attractive acquisition opportunities when they are burdened with a high cost basis or an owner's inability to see a path to value creation due to their negative history with the asset.

Another criterion for evaluating opportunities is the proverbial cliché of "location, location, location". Target markets should balance high barriers to entry with potential growth. High-barrier urban markets benefit from cap rate compression during economic growth, while exhibiting a measure of insulation from decreases in value during poor economic periods. Some lower-barrier markets present more risks in terms of supply and liquidity, but potential growth can compensate for these risks if an investor buys the right asset at the appropriate point in the cycle. We believe the most compelling current opportunities exist for primary assets in secondary growth markets and secondary assets in primary growth markets.

Lastly, investors should look for significant potential for value creation by targeting transitional assets which have suboptimal income streams in-place. Transitional assets require capital investment and active management in order to protect or increase their value and it is these assets' instability that provides the potential to capture upside through the value-add investment process. In addition, these are the assets that are most likely to be acquired at significant discounts from unnatural or disenfranchised owners.

Figure 4

Investment Characteristics	Capital Availability	
	Abundant	Scarce
Market	Major	Secondary
Income	Income Producing	Transitional
Size	Large	Middle Market
Sponsorship	Institutional	Entrepreneurial

Washington, D.C. Metro Office

The CenterSquare team has executed a value-add strategy on more than 190 investments during our 25-year history. We acquire fundamentally sound assets with manageable deficiencies at a cost basis advantage that allows the property to offer the most compelling rent-value proposition in any given market, thereby reducing relative risk. During the value-add execution process, we strategically add the key ingredients of capital and expertise until a high-quality finished product has been created to serve up to yield-hungry core investors.

Strategic Execution

The successful execution of a value-add investment business plan is the most crucial determinant of the investment's performance. To ensure superior execution of the business plan and maximization of end value, we believe in utilizing local operating partners to achieve a competitive advantage. Over the past two decades, the real estate asset class has solidified its place in the global investment universe. However, property operation and management remains very much a local business, requiring deep knowledge of economic drivers, preferred locations and rental rates. Well-aligned joint ventures with proven local operating companies can be highly efficient and effective ways for institutional investors to gain access to quality investment opportunities, along with the operational capabilities needed to implement the turnaround strategies for formerly-underperforming properties. The operating partner's interests are aligned through negotiated agreements which include meaningful co-investment and back-end economic incentives tied to investment performance.

The local operating partner model allows a national investor such as CenterSquare to have the superior, local intelligence about the market, tenants and history of an asset that can only be obtained with a constant presence in the local market. Such knowledge increases the accuracy of underwriting for each investment. In addition, quality operating partner relationships are important tools for finding new investments before they gain broad attention and for enhancing competitive positioning through acquisitions due to specific relationships with local brokers and/or sellers.

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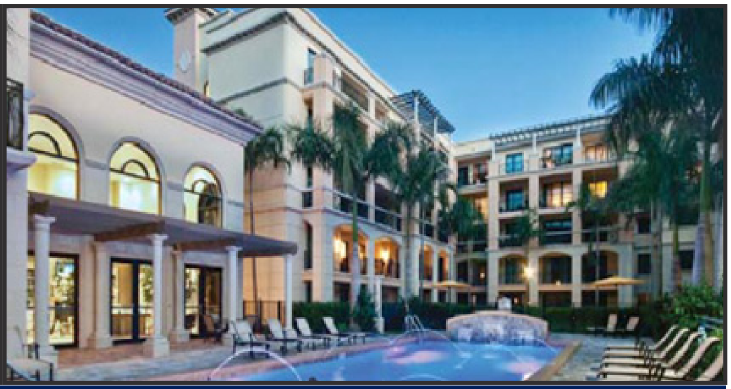
Before Value-Add Execution



After Value-Add Execution

The CenterSquare team combines the local expertise and relationships of our partners with the institutional protocols and experience crafted across a variety of property types through multiple investment cycles over the course of a 25-year history of institutional investment management. Active management is the key to realizing any successful investment. Significant upfront research enables an investor to make compelling risk-adjusted investments at attractive bases, but the environment is a dynamic one. An ongoing assessment of the variables that impact real estate value is required. CenterSquare has extensive value-add investment experience that provides us with the vision to anticipate potential events that will affect value and enables us to chart a proper course of action to maximize gain or minimize a negative impact.

At CenterSquare, every decision from initial evaluation through strategic execution to disposition is supported by disciplined processes developed over a lengthy history of real estate investment management. Ultimately, we are focused on determining an exit strategy that produces the highest risk-adjusted returns possible. Active monitoring of the capital markets helps inform when to optimally harvest the value created. Often this sell decision is driven by completion of the business plan, but occasionally the market will compensate owners for future potential income not yet created. Continuous analysis provides us with the tools necessary to perform a hold vs. sell analysis and evaluate whether future potential returns from taking additional execution risk are worthwhile, compared to a return that could be realized today.

Conclusion

As the Global Financial Crisis drifts further into history, the aftershocks and resulting impacts will continue to be felt. We believe that until the U.S. deals with its national and municipal debt, underfunded pensions and other structural issues, investors will continue to live with the threat that the tectonic plates moving beneath our feet will once again meet in a destructive collision. Accordingly, we feel that it is prudent to invest in assets that can be acquired at a competitive cost advantage with the potential for both increased yields through strategic execution and for enhanced total return through risk reduction. We believe that a middle-market, transitional asset, value-add strategy does just that as the real estate investment landscape has firmly shifted away from an Era of Acquisition and into an Era of Execution.

Authors

P.J. Yeatman is the Head of Private Real Estate at CenterSquare Investment Management and a member of CenterSquare's Management Committee. Mr. Yeatman is primarily responsible for leading the Private Real Estate business, including his role as Chair of the Private Real Estate Investment Committee, while retaining day-to-day responsibilities for the existing fund and separate account assets. He has over 22 years of real estate investment, redevelopment and restructuring experience in all property types and most major U.S. markets. Prior to joining CenterSquare in 2012, Mr. Yeatman founded CoveredBridge Ventures in 2011. Previously, he spent 11 years at Lubert-Adler Partners, last serving as its Senior Managing Principal. At Lubert-Adler, Mr. Yeatman participated in the raising of $6 billion of equity, and led the firm's activities in distressed and public to private transactions. Mr. Yeatman earned a Bachelor of Science in Economics and Marketing from Babson College and a Masters of Science in Real Estate from Massachusetts Institute of Technology. Mr. Yeatman was published in the Journal of Real Estate Economics and has been a guest lecturer at the Wharton School of the University of Pennsylvania. Mr. Yeatman served on the Board of Directors of both Mervyns and Central Parking Corporation.

Jeffrey Reder serves as a Senior Vice President in the Acquisition Group of CenterSquare Investment Management and is based in the Southern California office. He is responsible for the sourcing, underwriting and closing of real estate acquisitions and investment transactions in the western region of the U.S. Mr. Reder brings years of experience in both real estate and investment banking to his position. Immediately prior to joining CenterSquare, he served as Vice President for a private real estate investment firm where he was a member of the Investment Committee, headed the asset management department, led the evaluation and underwriting of prospective acquisitions and managed the day-to-day operations and leasing of properties nationwide. Previously, Mr. Reder worked as an investment banker in New York as a Vice President of Corporate Finance before returning home to his native Southern California. Mr. Reder holds a B.A. in both Economics and Psychology from Northwestern University.

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Disclosures

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