



INVESTING THROUGHOUT THE CAPITAL STACK

**MITIGATING RISK FROM VOLATILITY THROUGH THE
REAL ESTATE MARKET CYCLE**



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At National Real Estate Advisors, our sole investment strategy focuses on build-to-core fund management for institutional investors. We develop and redevelop properties, establishing portfolios of modern assets that over the long term can outperform older, existing buildings in competing for tenants and achieving higher occupancies and rents. A build-to-core portfolio consists of development and redevelopment projects, as well as stabilized, modern assets derived from the completed projects. Through the use of one investment manager, investors are able to realize cash flows from well-leased core assets, as well as appreciation from development projects built for less than the cost of acquiring existing properties. Additionally, investing throughout the capital stack utilizing both equity and debt can help mitigate fund risk through market cycles. This paper discusses how and when build-to-core investors can effectively invest throughout the capital stack to produce core-plus returns (returns higher than typical open-end core funds) but with less risk than opportunistic investments.

Investing through real estate cycles can present both opportunities and challenges. Coming out of the downturn in 2010, many disappointed investors were reluctant to invest, and others typically had trouble shifting strategies quickly to take advantage of market-bottom opportunities. Of course, market timing can be a fool's errand, but sound investment strategies should be designed to take advantage of market upturns and to hedge against inevitable declines.

No matter the stage of the cycle, the build-to-core investment focus remains on finding quality sites, strong partners and projects in leading U.S. urban markets with barriers to entry, diversified economies, mass transportation networks, intellectual capital and growth drivers. Ideally, the build-to-core investor looks for yields on development projects 200 basis points to 250 basis points above those sought for investments on existing buildings in primary markets, and even higher spreads in secondary markets. In managing a build-to-core fund successfully, portfolio strategies should utilize both equity and debt. Determining where and when investments will be made throughout the capital stack is driven by the interest rate environment, lender activity and economic trends, among other factors. The appropriate use of construction loans, mezzanine debt and preferred equity can position investments to take advantage of potential reversals or at least protect against temporary market declines.

Below are the general investment parameters for investing along the capital stack throughout the real estate cycle for a build-to-core strategy:

CYCLE STAGE	MARKET CONDITIONS	CAPITAL STACK
Early Recovery	Unemployment declining Low construction pricing Few new projects Vacancy rates decreasing Lack of bank financing	Equity Construction loans
Stable Economy	Approaching equilibrium Lowered unemployment Rising rents Increasing supply	Equity Construction loans Preferred equity/mezzanine debt
Late Cycle	Momentum investing Low cap rates High construction costs Slackening rent growth	Construction loans Preferred equity/mezzanine debt
Recession	High unemployment Rising vacancies Borrower/owner dislocation Favorable pricing	Equity (acquire new investments at discount)

EQUITY INVESTING

Early in Cycle: The focus is on equity investing — either investing directly or with well-positioned joint-venture partners. Pegging a market bottom is extremely difficult, but as unemployment rates begin to decline with renewed job growth, a window generally opens for equity investments to fund development and redevelopment projects. Construction pricing can be very favorable — material costs typically have declined, and contractors are willing to offer discounts to ramp up work. In addition, less competition usually exists for development financing early in the cycle. New projects with modern amenities and sustainable technologies can be positioned to come on line as vacancies decline and rents start to increase. As a result, a new project should out-compete existing older product.

Stable Economy: Fair construction pricing, steady job growth, controlled inflation and reasonable interest rates can continue to promote solid development equity investment opportunities into a maturing real estate cycle and allow enough time for projects to stabilize while the economy is still strong. But when certain cautionary signs appear, it may be advisable to seek less-risky debt structures lower down the capital stack for build-to-core investments. Those warning signals may include very low cap rates driven down by momentum investors, increase in supply, higher construction costs as demand for workers and materials rises, inflationary pressures leading to higher interest rates that eventually push cap rates higher, and entry into markets by inexperienced investors.

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DEBT/PREFERRED EQUITY INVESTING

Late Cycle: There is still opportunity to invest late in the cycle when a project's long-term prospects are favorable because of superior location and quality. A non-recourse construction loan offering high single-digit returns or a preferred equity/mezzanine loan pegged at mid-teens returns is often a more profitable capital stack position than equity when spreads have narrowed and lower yields are expected.

Construction Loans: When banks are pulling back from making loans and developers are hungry for financing, build-to-core investors can be well-positioned to fill the void at terms that are much less risky than equity, while gaining attractive coupon returns without being undercut by conventional lenders. The build-to-core fund manager requires the developer/borrower to have 30 percent to 40 percent of the total project cost invested in return for a non-recourse construction loan covering the remaining cost. While most banks are not eager to take back and operate projects, if exigencies arise, build-to-core investors must enter these late-in-cycle transactions with confidence that they have the experience necessary and are able to complete the project and secure permanent financing, if required. These debt investments can deliver high single-digit returns, helping to support core-plus performance. In the worst case of a default, the fund can take full control of a prime property at 60 percent to 70 percent of its cost and be positioned to ride out market dislocation, potentially registering greater upside gains as the asset owner in an eventual recovery.

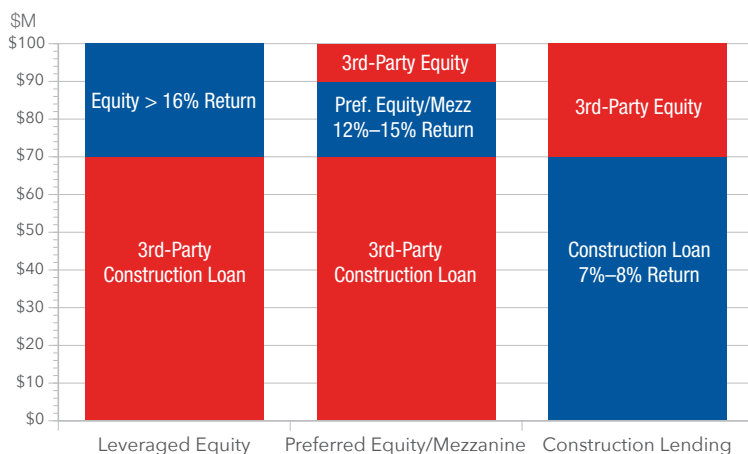
Construction loans with appropriate build-to-core returns also will be competitive early in the cycle because most conventional lenders are reluctant to re-enter the market before they are more certain that recovery is under way. When debt markets are more liquid, conventional volume lenders generally will provide more favorable terms to borrowers, and then build-to-core lending becomes more difficult.

Preferred Equity and Mezzanine Debt: Like construction loans, preferred equity and mezzanine debt can provide sound capital stack positioning to invest in build-to-core projects near the end of a cycle, when the risk-reward ratio begins to skew sharply to more risk and less reward. Again, invested capital is cushioned by a lower position in the capital stack. If the project is successfully completed, the build-to-core fund has secured a high interest-rate return to support core-plus performance parameters. The downside risk of assuming control of the project at a discount remains acceptable, assuming typical recovery scenarios, which could result eventually in substantial appreciation. Where a developer defaults before project completion, the build-to-core investor must assume the task of completing the development. In those cases, build-to-core fund managers with internal development expertise and project management capabilities are better positioned to ensure completion. A long-term investment view, supported by a fund's deep-pocket capital structure and vertically integrated development capabilities, can allow for riding through a market trough.

ACQUIRING SITES

Market Bottom/Recession: When markets turn illiquid and building values drop, opportunities can exist to acquire land or building sites that can be upgraded to higher uses in the future. For build-to-core strategies, the focus should remain on core urban infill, markets with high barriers to entry and diversified employment bases. This is the time to secure the next generation of opportunities, holding and planning for development or redevelopment at appropriate points in the coming recovery.

Targeted Returns Along the Capital Stack



Source: National Real Estate Advisors

The chart shows typical targeted returns for a build-to-core strategy along the capital stack in blue. It is important to remember that with a build-to-core strategy, the manager would always seek to invest at a level in the capital stack at which they would be comfortable owning the project and holding for the long term, if necessary.

SUMMARY

A well-capitalized build-to-core strategy can profit by proactively investing throughout the entire real estate cycle. Sophisticated build-to-core managers can utilize a combination of equity, preferred equity, construction loans and mezzanine debt to help position investments for solid performance, take advantage of changing market opportunities and weather most down cycles.

Investors can attempt to execute such a multifaceted build-to-core strategy using a single fund manager, through separate investments in multiple funds and/or one-off transactions. But they may struggle achieving the best combinations of equity and debt investments or finding the best opportunities to secure satisfactory overall risk-adjusted returns by pooling together investments from multiple managers.

While a build-to-core investor's main goal is to develop the highest and best use of an asset in the most desirable location, taking advantage of optimal market conditions, the vagaries of the real estate cycle can often interfere. This paper demonstrates how a comprehensive build-to-core strategy and investing along the capital stack can help investors secure prime investments throughout the market cycle, without limitation to market dislocations or narrow development windows.

NATIONAL AND BUILD-TO-CORE

Achieving solid build-to-core performance requires a focused advisor strategy and specialized development know-how, which many institutional advisers lack because necessary firm infrastructure is expensive and difficult to acquire. Advisers with development and project management skills can access opportunities that many managers cannot, providing a significant competitive advantage to investors seeking investments in new properties.

At National Real Estate Advisors, we have been executing a build-to-core strategy for more than 15 years, concentrating development activities in leading U.S. urban markets where core investment opportunities exist. The company has built relationships with many leading developers to undertake joint ventures and, more important, accumulated significant internal project management expertise with in-house capabilities and personnel to develop our own highly complex mixed-use projects. At this time, our National Development subsidiary is directly developing four major projects for client accounts in San Francisco, Los Angeles and Philadelphia, totaling more than 3.5 million square feet of space and nearly \$900 million in development costs. National also functions as a lender, across the capital stack, to provide project financing and help hedge project risk for investor clients. We are not a merchant builder — our open-end build-to-core fund provides the opportunity to invest immediately in a \$5.4 billion (gross) and \$1.9 billion (net) portfolio of income producing real estate diversified by property type and geography as well as development projects, which become part of the stabilized portfolio.

National seeks to capture the risk-return benefits of a well-executed build-to-core strategy — creating and constantly refreshing a property portfolio able to command high market rents and occupancies with enhanced appreciation potential.

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