MARCUS PARTNERS

Viewing opportunities through the **prism of disruption**

An interview with members of Marcus Partners' leadership team

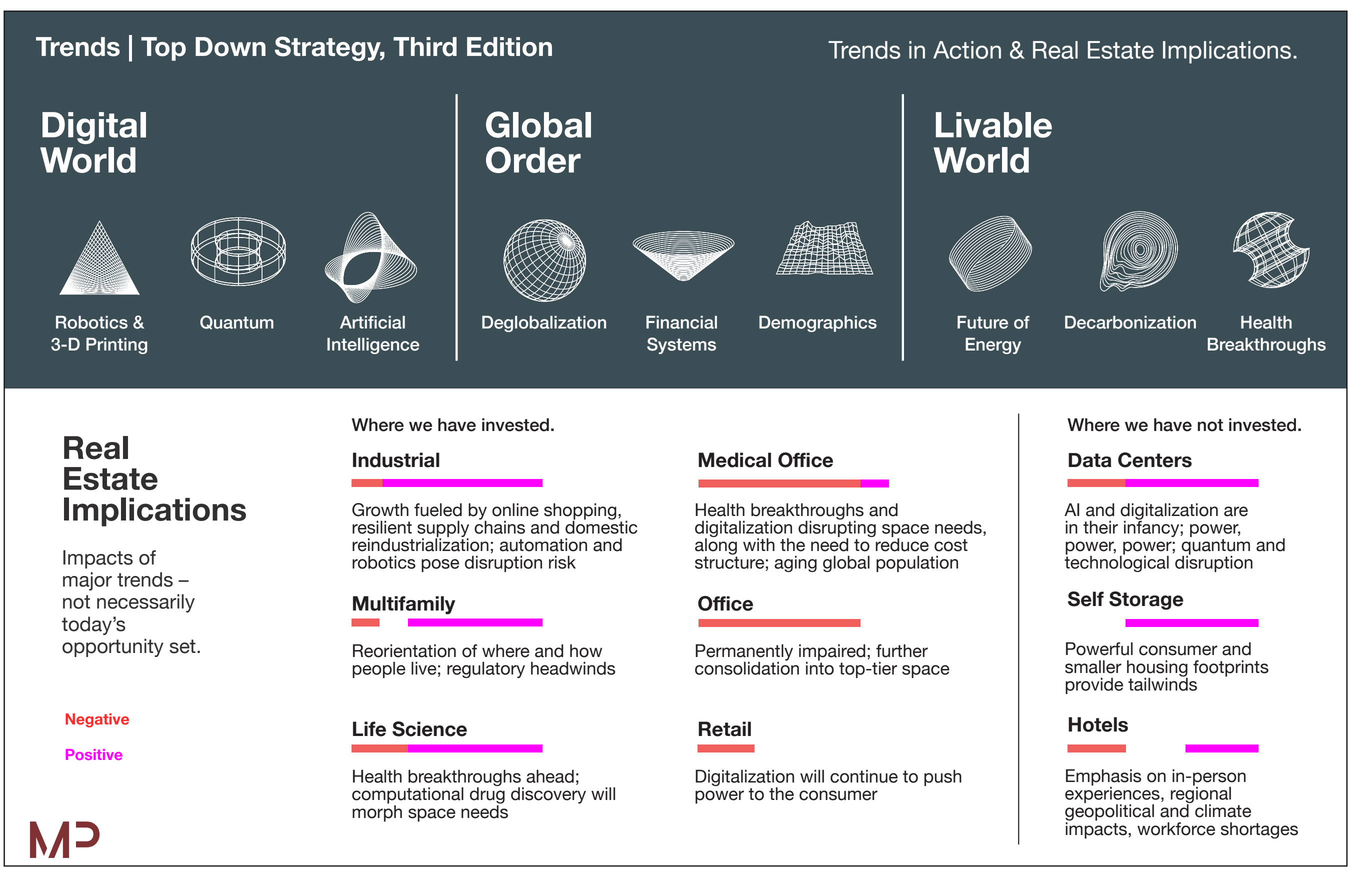
Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with members of Marcus Partners' leadership team: **Paul Marcus,** chief executive officer; **Ryan McDonough,** chief investment officer; and **Patrick Sousa,** chief operating officer and head of capital. Following is an excerpt of that conversation.

Tell us about your strategy. How do you make money?

Our core business strategy has always been to acquire underutilized or broken assets – be it financially or physically – and fix them by adding improvements or changing their use. Today, we are leveraging our expertise across real estate disciplines and our vertically integrated platform to create or manufacture core industrial and multifamily product that is in alignment with secular themes and evolving end-user demands. We expect these assets will generate strong interest from the growing pool of institutional capital sources seeking to own this product. Often, this is via stranded asset opportunities, such as office teardown to industrial or multifamily, as well as other change-of-use strategies. As we work to effectuate this strategy amid a volatile interest rate environment, we are highly focused on creating a spread between stabilized or development yields and their associated exit cap rates – working to create 150 basis points to 300 basis points of spread, depending on the asset class and investment profile. This spread is how we deliver profits to our investors. Additionally, this spread serves to protect capital by creating a margin of safety in a potential higher-for-longer rate environment.

You recently completed the Third Edition of your "Trends | Top Down Strategy" thought piece. Tell us about it.

Our "Trends | Top Down Strategy" is a macro perspective on some of the world's major trends, their impact on real estate and the resulting opportunities and risks they present. Our 2018 First Edition played a critical role in our pivot out of office in 2017–



Trends | Top Down Strategy, Third Edition
Our major takeaways

- Factors negatively impacting medical office have accelerated (e.g., telehealth, Big Tech's push to disrupt the industry, AI's impacts, the need to reduce cost structure), **significantly lowering our go-forward conviction in the sector** (one in which we have successfully invested over the years).
- AI and quantum compute will have an arc effect on life sciences real estate demand, initially driving an increase as breakthroughs are enhanced, **but ultimately computational advancements will reduce the need for lab space. This could happen sooner than we previously thought.**
- **Further consolidation of our investment focus into industrial and multifamily.** Capital flows into these sectors necessitate a vertically integrated team to effectuate value-added strategies and provide a margin of return.
- **Ability to move across asset classes** (even within a fund life) is crucial as the "rate-of-change of change" continues to accelerate.
- **Domestic reindustrialization and the onshoring of manufacturing** play an important part in our go-forward industrial investment thesis.
- **Power, power, power.** Increased demand for power and the decarbonization investment themes will become very powerful in augmenting industrial returns.

2018. At that time, we believed office had escalating disruption exposure risks from a variety of factors, including declining lease durations, escalating tenant improvement costs and evolving artificial intelligence technology. In Fund II, a 2014 fund, we invested more than 50 percent of the vehicle into office, which was predominately harvested with profits before COVID-19. In Fund III and Fund IV, there is zero office. Today, industrial real estate represents 52 percent of the portfolio, and multifamily in supply-constrained markets represents a further 34 percent.

In our Third Edition, we divide the major trends into three categories: digital world, global order and livable world. Within the digital world, for instance, in the short-to-medium term, we believe artificial intelligence will be a continued tailwind for industrial real estate, as you think about ecommerce and the marriage of search and commerce. Conversely, we think artificial intelligence and other current factors will be a headwind for medical office in the medium-to-long term.

Our central belief is that investment success will increasingly be predicated on flexibility and the ability to view real estate opportunities through the lens of accelerating disruption. Today, we are also seeing an increase in disruption-oriented opportunities driven by a confluence of factors: (1) the collective impact of macro trends redefining how real estate is designed, used, operated and valued – creating an increased volume of stranded assets; (2) higher-for-longer interest rates impacting assets, particularly those with near- and medium-term debt maturities; and (3) the "pretend and extend" strategy employed by so many is becoming more challenging to implement. These factors are starting to force capitulation among some real estate owners and lenders, creating an uptick in both equity and debt-related opportunities.

Can you speak to specific examples of opportunities and risks created by these trends?

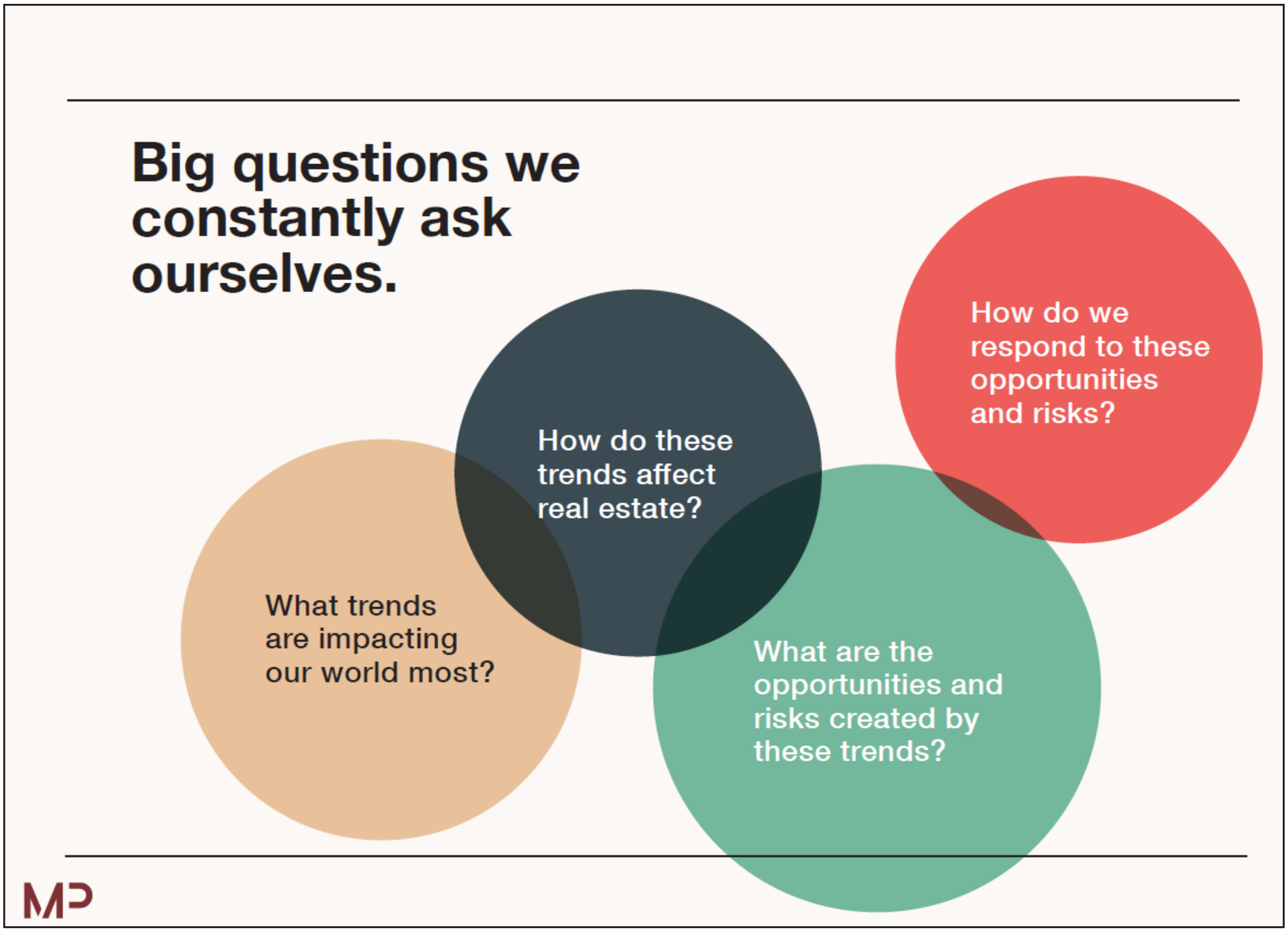
With regard to stranded assets affected by macro trends, we are actively working on two office-teardown-to-industrial change-of-use opportunities – one in Metro Boston and one in Northern New Jersey. This is a strategy we have now employed many times. For instance, we are currently delivering a 450-unit multifamily project in Westchester County, N.Y., on a site previously improved by an obsolete office building we acquired via an online auction process.

Could you discuss how the Third Edition of your "Trends | Top Down Strategy" thought piece is informing your investment decisions?

As part of our major takeaways from the Third Edition, we noted: "Further consolidation of our investment focus into creating cash-flowing industrial and multifamily; capital flows into these sectors necessitate a vertically integrated team to effectuate value creation in these strategies." Along with this consolidation, we have further refined our subsector focus areas within industrial and multifamily. For instance, our industrial subsectors include light industrial, logistics, build-to-suit manufacturing and industrial outdoor storage [IOS]. Furthermore, as we have been discussing for quite some time with our investors, in the medium term, we expect persistent tailwinds for inflation and continue to plan for higher-for-longer interest rate scenarios. Today, approximately two-thirds of our acquisitions focus is on subsector strategies that should allow us the ability to pass inflation on to end-users and their clients, for instance, light industrial and multifamily in supply-constrained markets.

You also note domestic reindustrialization as part of your thesis. Could you expand on what you are seeing for opportunities?

In Metro Boston, we recently delivered a 432,000-square-foot build-to-suit manufacturing facility for a Swedish-based climate controls company. We feel the onshoring of manufacturing is more structural than cyclical in nature and anticipate this



segment of the economy will continue to yield opportunities. Today, it is quite clear this investment theme is accelerating into the next phase of growth, and we are actively engaged in conversations with users, although we know from experience these transactions take time and patience. These opportunities represent a cross-section of the U.S. economy and extend far beyond mission-critical items, such as semiconductors. Global geopolitical realignment, supply-chain resilience, currency risk and the ability to pass inflation through in a correlated manner to customers are all top of mind for global manufacturers. Furthermore, as robotics and artificial intelligence continue to transform the global economy, labor costs are becoming less of a factor in determining the location of manufacturing facilities – power availability and cost are becoming more important.

Do you see this impacting other real estate sectors?

We expect this could have a multiplier effect within the industrial real estate sector, with increased demand for light industrial and logistics space to support a growing domestic manufacturing base.

What is your outlook for multifamily?

Fundamentals in multifamily remain heavily desynchronized, bifurcated between supply-constrained markets and non-supply-constrained markets. Fundamentals in supply-constrained markets, such as Metro Boston and Metro New York (where the entirety of our current multifamily portfolio is located), remain healthy, with moderating but positive rent growth and low vacancy rates. Along with rent-buy ratios keeping many prospective home buyers in the renter pool, high barriers to new construction continue to buoy fundamentals in these markets. Recently, the Commonwealth of Massachusetts released data showing that Massachusetts needs to produce approximately 220,000 units of housing by 2035 to meet demand and make meaningful progress to combat its housing shortage crisis – this represents more than double the amount of housing built during the past 15 years in Massachusetts.

Fundamentals in non-supply-constrained markets, such as the Southeast, remain challenged. These markets are working through a glut of new supply, which has contributed to negative rent growth and rising vacancy. While construction starts have declined significantly, we believe fundamentals will continue to weaken in the near and medium term, as these markets work through the elevated supply. We believe these dynamics, along with impending loan maturities, will create some compelling investment opportunities. In these non-supply-constrained markets, we are pursuing recently delivered multifamily assets that can be acquired below the developer's cost basis.

Broadly, asset-level expenses, including taxes, payroll, utilities and particularly insurance, especially following recent natural disasters, remain a major factor for the asset class. Furthermore, in addition to tariffs and their impact on costs and schedule, we are keeping an eye on rent-related regulatory risk, including litigation against algorithmic rent pricing.

What is something noteworthy you have been focused on during the past year?

We believe "DPI is the new IRR" [distributed to paid-in capital is the new internal rate of return]. We continue to be focused on returning capital and divesting assets for which we have completed our business plans. During the past seven quarters, we have sold $410 million of multifamily and industrial real estate across 15 assets. Notably, we sold 12 industrial assets in line with or in excess of our upside acquisition underwriting, and the remaining assets sold in line with our base-case acquisition underwriting. Generally, the transaction market remains volatile, characterized by brief windows of sales activity followed by slowdowns, and sellers need to be ready to act decisively when the transaction window is open, largely impacted by interest rate movements. In 2025, we will continue to opportunistically bring assets to market for divestment and look to execute during sale windows. Naturally, while we continue to focus on returning capital to our investors, we also remain ready to hold assets when pricing does not pan out.

How are you thinking about your team in today's environment?

We remain highly cognizant of our team as we traverse the "new normal." We continue to focus on embracing an "all-weather" company mentality, grounded in resilience and adaptability. We have doubled down on the firm's cultural emphasis on cross-training, enabling a deep bench of team members who are able to work across property sectors, geographies and working groups. This has been a critical strength of our firm. We also continue to build out the firm's "third generation" team, providing the partners with bandwidth to take on additional responsibilities associated with leading the firm, while simultaneously providing opportunity for this next generation.

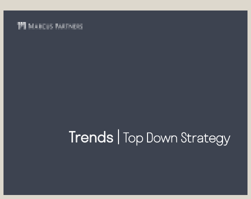
> *Success in commercial real estate investing will increasingly be predicated on flexibility and the ability to view opportunities through the prism of disruption.*

A final word?

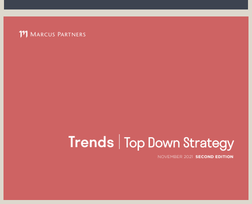
Thinking ahead for 2025, we continue to believe it is not about making the most accurate prediction of the path for the economy or macro environment. Instead, it is about understanding there are many paths diverging before us, and they lead to vastly different destinations. This means caution and flexibility will be paramount. As always, we will continue to focus on making investments with resilience and a margin of safety where we have competitive advantages. Late last year, we enjoyed a comment made by Jeff Bezos at the 2024 *New York Times* DealBook Summit: "One observation I would have is that, I think, it's generally human nature to overestimate risk and underestimate opportunity." Plainly, we believe there is, and will continue to be, opportunity amid the volatility. We also believe this volatility will provide opportunities with increased returns.

MARKET FORESIGHT

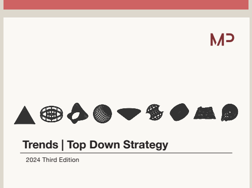
Our **Trends | Top Down Strategy** thought pieces are macro perspectives on some of the world's major trends, their impact on real estate and the resulting opportunities and risks they present. As a result of this thinking, in 2018, we increased our allocations for industrial and multifamily and made our last office investment.



First edition 2018



Second edition 2021



Third edition 2024

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CORPORATE OVERVIEW

Marcus Partners is a vertically integrated real estate private equity firm with a 30-plus year history of successful investment, development and management in knowledge-based East Coast markets. We focus on value-added investment strategies across industrial, multifamily and other select property types where we can create value, provide increased margins of safety and maximize risk-adjusted returns.

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