THE RUTH GROUP

August, 2020

WHITE PAPER: MIDDLE MARKET PRIVATE EQUITY REAL ESTATE APPETITE

EXECUTIVE SUMMARY:
MIDDLE MARKET PRIVATE EQUITY FUND INVESTOR INTERVIEWS

We recently spoke with 30 commercial real estate middle market private equity funds to assess their current investment appetite and post-COVID CRE outlook. We spoke about their dry powder, current fundraising activity, property type appetite and view of COVID-19 impact. As we are primarily middle market office investors/operators, we were particularly interested in investor appetite for low-rise and mid-rise office opportunities, and the for the office sector generally. We also explored their view on other asset types. We provide a recap without attribution in the following pages.

If you are too busy for the deeper dive, a few takeaways jumped out at us, some expected and some unexpected:

Many more of the investors we spoke with have a more positive outlook (60%) for suburban office post-COVID than those that have a more negative outlook (17%).

Lower risk capital investors (Pref Equity/Light Value Add) are more actively seeking deals today than those investing higher risk capital (Heavy Value Add/Opportunistic).

The number of investors pursuing the same opportunities in this market is noteworthy, and with debt capital available again for those investments, most investors complained that pricing has recovered for the lower risk alternatives to pre-COVID levels.

Opportunistic investors disproportionately are taking a "wait and see" attitude, with few actively seeking to transact. Most are waiting for distressed pricing as sellers are forced to exit or recapitalize. With most investors reporting significant dry powder, all waiting for a price correction, one questions how far prices ultimately will drop.

Capital remains abundant, with the bigger funds getting bigger. It is a tough environment for younger funds to attract new institutional commitments.

OUR SAMPLE:
THE 30 FUNDS WE SPOKE WITH

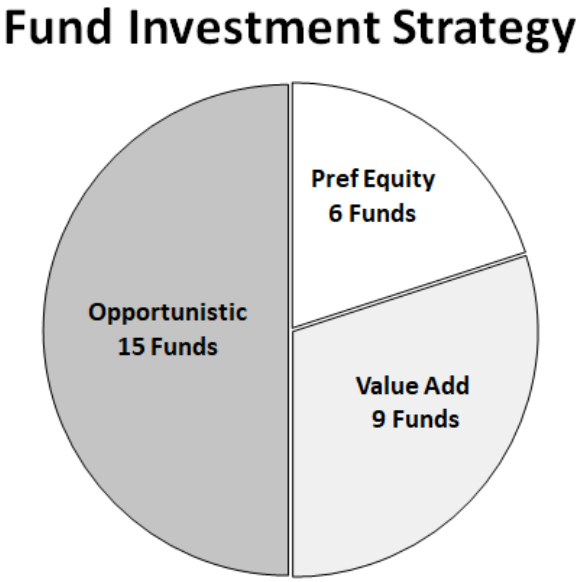
Our sample of private equity funds covers investors representing a range of Opportunistic, Value-add and Preferred Equity strategies. The sample includes fund managers with a track record in excess of a dozen prior funds, through managers hoping to raise their second fund soon, with most in between. Our sample includes fund managers that only make equity investments and managers that make both equity and preferred equity investments (either in one vehicle, or through multiple funds). Many of the large fund platforms have the ability to make investments in public securities (REIT common and preferred, and CMBS) and may add side-car investments for larger deals with select fund investors.

Our sample can be mapped by reported minimum equity check and target property level gross return:

Minimum equity check per deal: Ranged from $5 mil to $25 million; the median minimum check per deal was $10 million in our sample.

Property level target gross returns: Levered returns ranged from mid-teens to the low 20%'s.

Opportunistic investment strategy skew: Half the sample is seeking opportunistic returns, with the median target gross return being 18%.



COVID INVESTING:
WAITING FOR DEAL FLOW

The immediate reaction of most of our respondents to the COVID shutdown was to limit downside risk in their existing portfolios, and not add more risk with investments in new deals. Several reported asset management required all-hands-on-deck for the first weeks of the shutdown.

The majority resumed looking for new deals in the second quarter, while a small group have stopped equity investing for the foreseeable future. The most in favor property types are less risky assets. Investor interest drove a rapid recovery in pricing for Multifamily and Industrial properties (more on property type demand below). The pace of investments activity continues to skew to less risky investment strategies.

Preferred Equity

Investors are actively pursuing deals. Several mentioned having looked at 14%-15% yielding "gap" preferred equity opportunities in multifamily properties coming out of construction, or facing bridge loan maturities, given GSE lower loan advance levels. That market quickly tightened to 12%-13% with abundant investor appetite. **Deals are getting done at pricing close to pre-COVID levels in the Preferred Equity space.**

Value-add

Investors continue to be disappointed with the bid-ask spread between property buyers and sellers. **Seller expectations may have declined 5%-10%, while buyers are looking for +/-20% price adjustments given more conservative underwriting and less favorable debt terms.** The relatively small number of deals that did get done seemed to almost all be pre-COVID stalled deals that were repriced. On a positive note, debt is available in the 60-65% LTC level for lighter lift deals. Multiple investors mentioned looking for opportunities to buy from owner-occupier sellers in need of reducing debt on their balance sheet.

Opportunistic

Investors cite a lack of distressed opportunities, as owners have not been forced to sell or recapitalize yet. Some expressed optimism that activity will pick-up in the third quarter as distressed sellers face loan maturities, expiration of lender forebearance and tenant bankruptcies. **Cash bids may be the order of the day, as very few lenders have appetite for heavy lift short-term lease-up risk.** The hospitality sector seems to be on everybody's radar as the most likely source of distressed opportunities in the second half of the year.

SUBURBAN OFFICE:
RECENT POSITIVE TRENDS WILL BECOME MORE PREVELANT POST-COVID

Almost all the investors we spoke with believe that white-collar workers want to return to the office, and work from home will not survive as a post-COVID new paradigm (see Gensler research). However most believe the office people will want to return to will be different, as COVID will accelerate trends that were already emerging prior to the shutdown. As leases expire, investors are anticipating more tenant demand for well-located and well-amenitized suburban office. Investors cite the following in support of that thesis:

Hub & spoke over a centralized block of floors

Many tenants will transition to multiple offices throughout a market from a large office block in a central location. **Locating operating units that share limited interaction in a central location provides little productivity efficiency at the expense of work-life balance.** One investor described this as the "democratization of work the environment."

Work-from-home pushes *work-close-to-home* model

While the work-from-home model will not survive, people have become accustomed to the life-balance benefits of having no commute. **Post-COVID, people will place a higher premium on working close to where they live.** As the Baby-boomers did before them, Millennials have begun to move to the suburbs to raise families. They will want to office close by.

Demand for quality workspace continues

Tenants will continue to compete for talent by providing workspaces that are integral to employee work-life experience. **The recent trend toward creative office with indoor/outdoor common area space will become more prevalent post-COVID, as tenants seek workspaces with ample fresh air.** For example, expect more demand for low-rise buildings with roll-up doors and balconies in campus-like settings.

Amenities will matter

Leaving the CBD does not mean leaving the desire for amenity rich properties behind. Well-located properties with ample walkable amenities and convenient public transportation will out-perform long term.

A pause in the move toward greater density

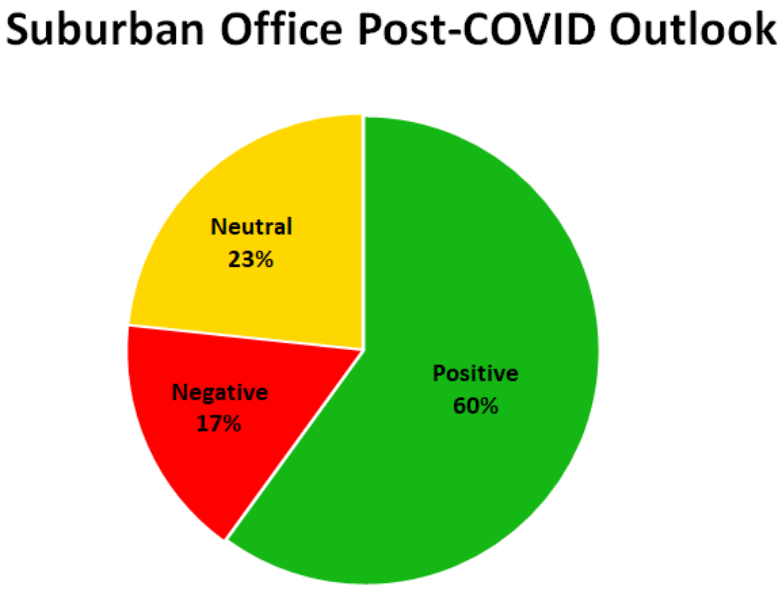
In the short-term investors anticipate tenants will want to give COVID weary employees ample space to work, causing a pause in the push toward increasing office density. **Hoteling will be less in favor accordingly, with less emphasis on density until COVID has become a memory.**

SUBURBAN OFFICE:
A MORE POSITIVE INVESTMENT OUTLOOK POST-COVID

Most investors felt these trends would be lasting and would drive a change in their investment thesis toward suburban office; **60% reported having a more positive outlook for Suburban Office post-COVID than before.** Those investors anticipate there will be a flight to quality in investment capital as there will be among tenants.

Active investors almost uniformly expressed interest in innovative, well-located properties that can justify premium rents rather than competing on price. For example, properties that appeal to tenants with client facing and/or high collaboration functions will out-perform. Submarkets that are driven by those tenant uses are preferred.

Conversely there is limited interest in generic, undifferentiated suburban boxes. Submarkets dominated by back-office tenants are of less interest. In the words of one investor, **if it was broken pre-COVID, discounted pricing post-COVID is not going to interest them.** And value-add turnaround business plans will require significant conviction.



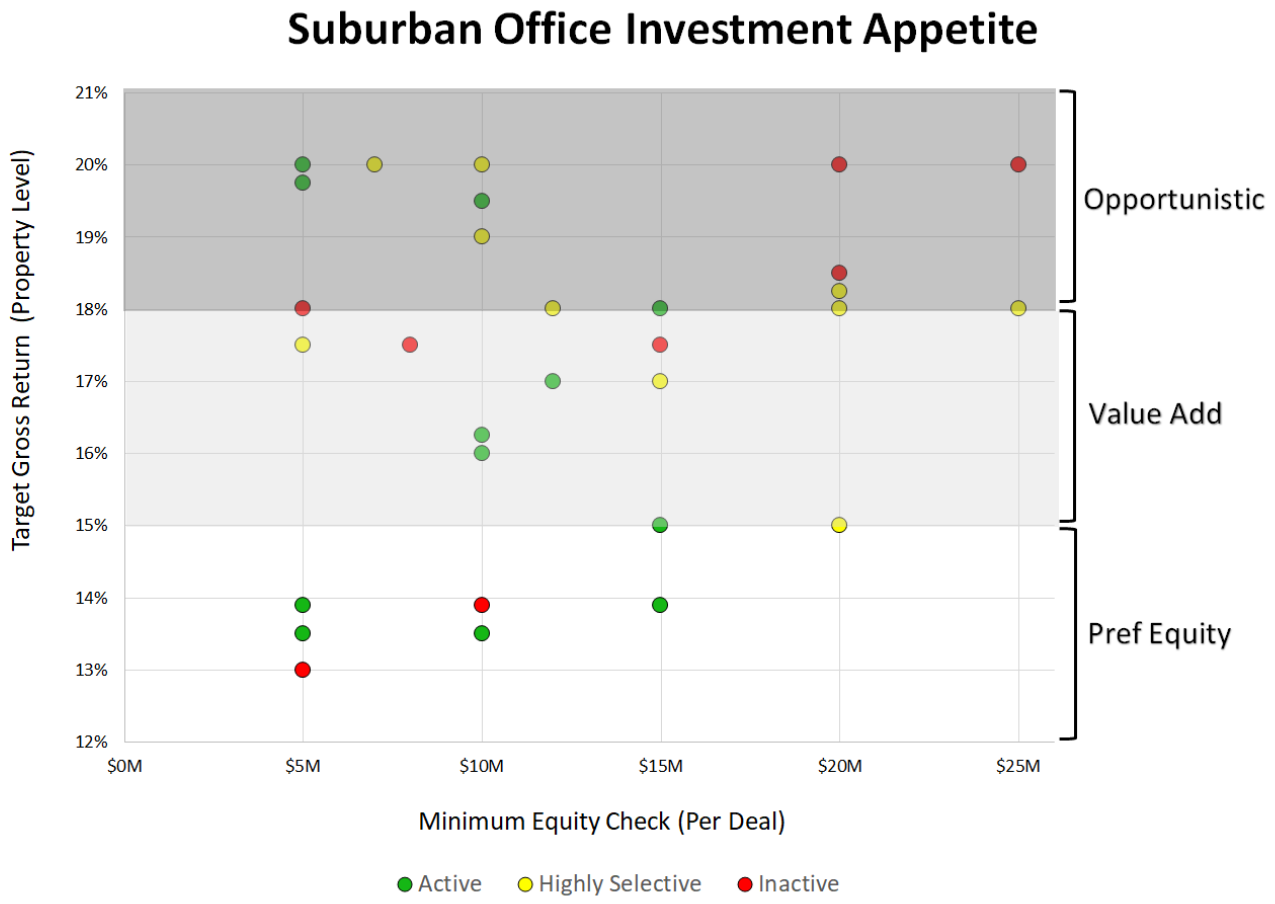
SUBURBAN OFFICE:
INVESTMENT APPETITE MAP

We mapped our sample by minimum check size per deal and property level gross target levered return. (Note: Preferred Equity funds are mapped to target preferred return.) We were particularly interested in how investors would describe their current interest in suburban office deals. We found the middle market private equity funds could be categorized into three general buckets, and we shaded each accordingly in our scatter plot investor map.

Active (green): Seeking opportunities to invest at market clearing prices; while underwriting assumptions have changed, and bid pricing accordingly, these investors are not screening for deeply distressed pricing.

Highly Selective (yellow): Getting any office deal done, suburban or CBD, would be a high bar and must be a unique situation with strong conviction in the investment thesis, and most likely at deeply distressed pricing.

Inactive (red): Not transacting in office currently, suburban or CBD.



SUBURBAN OFFICE:
INVESTMENT APPETITE SUMMARY

Lower priced capital is available: We found many more of the low to mid risk capital investors (Pref Equity/Light Value Add) are actively seeking suburban office deals today than those investing higher risk capital (Heavy Value Add/Opportunistic). **Almost all of the Pref Equity and Light Value Add investors are seeking to transact.**

Debt and equity capital is available for light lift value add deals, preferably for higher quality buildings with long WALT and credit tenants. There is a bid-ask spread between buyers and sellers, driven by more conservative underwriting assumptions and lower leverage levels, that is slowing transaction pace. Most investors are underwriting negative (2021) and flat (2022) rent growth. However transactions will get done with most investors anticipating a post-COVID return to normal in two to three years, and as sellers adjust to lower valuations with price discovery.

Opportunistic capital is mostly on the sidelines: As we noted in the introduction, Opportunistic investors disproportionately are taking a "wait and see" attitude toward suburban office, with very few actively seeking to transact. **Only four of the 18 high teens/low twenties gross return investors we spoke with would say they are actively transacting at today's prices. And the bigger the equity check, the less likely investors will be active.**

A significant majority of Opportunistic investors is waiting for a distressed pricing correction. Most site lease-up risk, a lack of debt capital and more conservative post-COVID underwriting assumptions. And the longer the COVID shutdown continues, rent collections may start to decline. There is ample capital waiting on distressed pricing, but not much yet to buy.

CBD OFFICE:
RIPE FOR DISRUPTION?

Conversely investor outlook for CBD office is much less positive. **Most investors anticipate CBD office will underperform, with one investor describing downtown office in 24/7 coastal cities as "the most ripe for disruption of all property types."** Investors anticipate CBD office tenants will return from the shutdown after suburban office tenants return. Outlook for vacancy and rental rates seems uniformly bearish, and there is very limited appetite for CBD office with large lease-up exposure. For example, one investor foresees a downtown LA permanent vacancy rate above 20%. (Note: the recent marketing of the US Bank Tower in downtown LA reflects this bearish market sentiment.) Civil disturbances in large cities are contributing to a view that many tenants may opt to reduce their presence in America's urban core.

OTHER PROPERTY TYPES:

MULTIFAMILY

Virtually 100% of the respondents report interest in MF properties as a safe harbor for deploying capital. As with the MF Preferred Equity mentioned above, pricing for equity in MF deals also quickly tightened 0% to 8% discounts to pre-COVID price talk, with those markets with the greatest tourism exposure posting the largest discounts.

INDUSTRIAL

Demand for Industrial properties is also robust, with virtually 100% of those investors that are deploying equity expressing interest in the property type. **Pricing for state-of-the-art Class A industrial properties has risen over pre-COVID pricing.** One investor reported selling an Industrial property in the Southeast during the shutdown above their pre-COVID BOV. Willingness to assume Class B lease-up risk is far greater than for other property types.

HOSPITALITY

Most Opportunistic investors are waiting for the shoe to drop in Hospitality. While very little is trading, multiple investors anticipate that when lender's stop extending forebearances, distressed properties will be brought to market. The most vulnerable assets are full service hotels held by thinly capitalized ownership with pending loan maturities.

RETAIL

Grocery anchored retail interest is asset specific. **Virtually no interest within our investor sample for troubled retail needing a turnaround.**

SELF-STORAGE

Investors report significant investor interest, although assets are difficult to find in size. There is positive investor sentiment given the perception of counter cyclicality in a downturn.

CAPITAL MARKETS OPPORTUNITIES

Several investors whose fund docs allow investing in REIT common and preferred, CMBS securities, and Private Debt reported taking advantage of opportunities until the capital markets recovered. **Should the public markets and/or private debt markets sell-off again, anticipate more activity.**

DRY POWDER:
THE BIG ARE GETTING BIGGER

Capital remains abundant. **Most funds we spoke with are sitting on large amounts of dry powder, with availability ranging from hundreds of millions to many tens of millions.**

A small subset of funds in our sample is actively raising capital now, with larger, established platforms reporting little difficulty securing commitments. Select smaller platforms are having less success, particularly with funds that invested *first-closing* capital pre-COVID. Some newer platforms have pushed out raises. With travel restrictions and the inability for institutions to conduct onsite diligence of new managers, it is a difficult environment in which to attract new institutional relationships. Conversely, it is a very favorable one for tapping existing investors for additional commitments.

THIS IS NOT GFC2

With the amount of capital there is on the sidelines, we are struck by how different the COVID shutdown is from the Great Financial Crisis. Investors recall that early investors last cycle did not do well, and more patient investors were rewarded with better returns. However the GFC was primarily an illiquidity driven crisis. With the public equity and debt markets flush with capital, the COVID shutdown has been anything but that. CMBS spreads have just about returned to their pre-COVID levels, a return that did not occur for many years last cycle.

While there is much debate over when we will return to normal, there seems little debate that we will. With abundant private equity capital poised for distressed pricing, one has to wonder if pricing will recover quickly for distressed real estate assets, and if the story written about the big money made in this downturn will be about those that got in early.

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