DavidsonKempner

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# Dislocation Drives Opportunity: The Case for Opportunistic Real Estate

## KEY TAKEAWAYS

- While there is a persistent opportunity to achieve opportunistic returns across market cycles, we believe that current market dynamics are creating a target-rich environment for distressed and special situations real estate assets.
- Historically, the best performing vintages of non-core real estate funds have been initiated during times of recession or in their immediate aftermath.
- Opportunistic investments target unique, typically complex investments that require specialized and creative acquisition and management expertise. As such, manager and sector selection are critical.
- Potential benefits of allocating to private real estate include diversification, attractive risk-adjusted returns, inflation protection, income generation and potential tax benefits.

*After years of sporadic opportunities, the market is entering a far more robust investing environment due to the ramifications of higher rates following a prolonged period of rates near zero. While this cycle is likely to feature opportunities across a wide range of industries and asset classes, real estate could be a particularly active asset class given its upcoming maturity profile and liquidity constraints.*

*Specifically, we believe opportunistic real estate presents a target-rich environment at this time, more than three years into the post-pandemic aftermath and the capital market dislocation caused by the elevated rate regime. Even as rates reverse course and the longer-term outlook improves, market volatility will likely continue—and continue to create advantageous entry points for distressed and special situations real estate assets. Notable investment themes within the context of the current environment include digital infrastructure and emerging industrial, as well as over-levered forced sellers in high barrier-to-entry markets.*

## WHY PRIVATE REAL ESTATE?

The universe of investible global commercial assets in real estate is diverse and immense, with an estimated value of $62 trillion.[1] To put this in context, the equity market cap of global publicly traded equities is $115 trillion.[2] The private real estate market offers investors access to investment opportunities that generally target property acquisition, development and management in the traditional sectors of office, retail, multifamily, industrial and hospitality, as well as alternative sectors such as self-storage, senior housing, data centers and manufactured housing.

Institutional investors like pensions, endowments and foundations seeking to enhance the risk-adjusted returns of a broader portfolio have long appreciated the benefits of allocating to private real estate. Individual investors may also consider allocating to private real estate, to avail themselves of similar benefits which may include: diversification, attractive risk-adjusted returns, inflation protection, income generation and potential tax benefits.

## DIVERSIFICATION

Historically, private real estate has exhibited a low correlation to equities, bonds and listed real estate, creating a diversification benefit. A key benefit of a portfolio with low correlation among its various assets is reducing volatility while still potentially increasing overall returns.

### Private Real Estate Exhibits Low Correlation to Other Asset Classes, Creating Diversification Benefits

| Correlations | Core Real Estate (ODCE) | Value-Add Real Estate | Opportunistic Real Estate | Equities (S&P 500) | Bonds (Bloomberg Agg) | Listed Real Estate | Core RE Debt | Non-Core RE Debt |
|---|---|---|---|---|---|---|---|---|
| Core Real Estate (ODCE) | 1.0 | | | | | | | |
| Value-Add Real Estate | 0.8 | 1.0 | | | | | | |
| Opportunistic Real Estate | 0.7 | 0.8 | 1.0 | | | | | |
| Equities (S&P 500) | 0.1 | 0.2 | 0.3 | 1.0 | | | | |
| Bonds (Bloomberg Agg) | -0.1 | -0.2 | 0.0 | -0.1 | 1.0 | | | |
| Listed Real Estate | 0.2 | 0.2 | 0.4 | 0.6 | 0.2 | 1.0 | | |
| Core RE Debt | 0.0 | 0.0 | 0.2 | 0.1 | 0.7 | 0.3 | 1.0 | |
| Non-Core RE Debt | 0.8 | 0.9 | 1.0 | 0.3 | -0.1 | 0.4 | 0.1 | 1.0 |

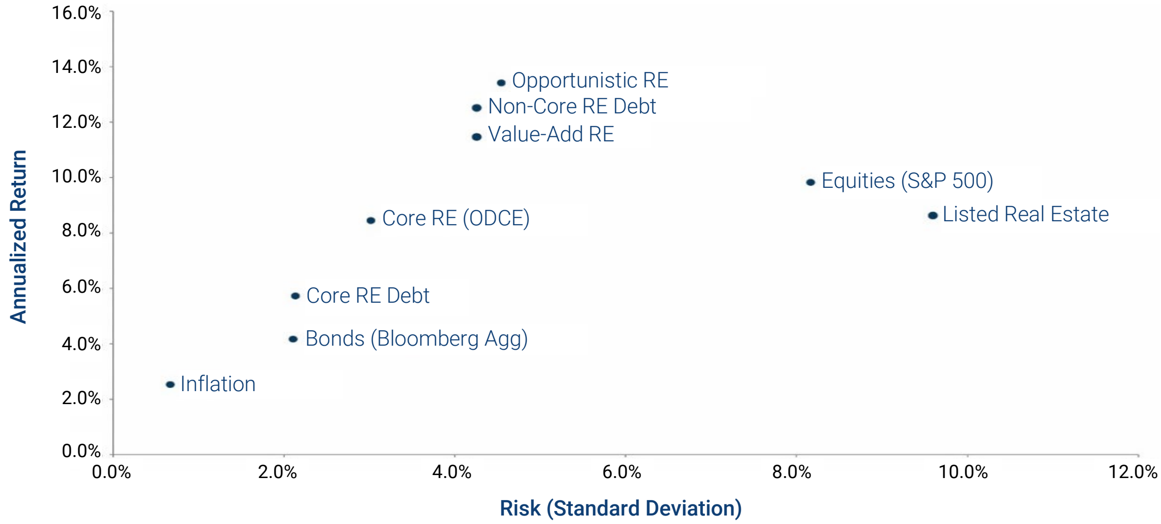
*Source: The Townsend Group (May 2024)*

## ATTRACTIVE RISK-ADJUSTED RETURNS

Private real estate investments within a broader, diversified portfolio can deliver equity-like returns with lower volatility, which would improve the overall risk-return profile of the overall portfolio.

### Private Real Estate Has Provided Long-Term Risk-Adjusted Returns Relative to Equities and Bonds

**Historical Risk & Returns Across Real Assets (Past 30 Years)**



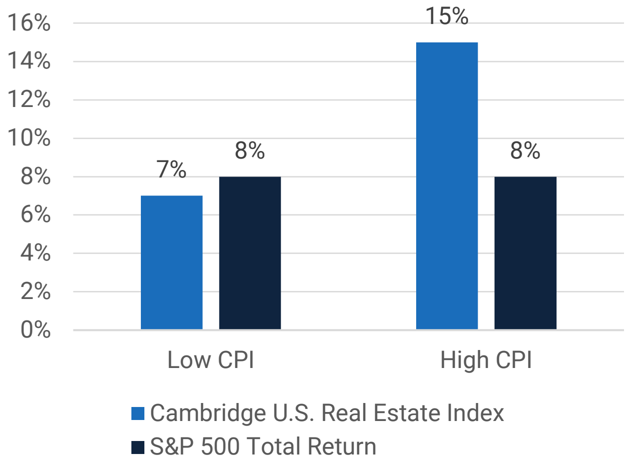

*Source: The Townsend Group (May 2024)*

## INFLATION PROTECTION

Real estate produces income streams that can reset over time due to market rent growth and contractual rent step ups. Rents often rise with inflationary expectations, sometimes even in excess of inflation. In declining inflationary environments, real estate typically continues to perform relatively well as rents can continue to appreciate while interest rates, cap rates, and financing costs trend down.

### Commercial Real Estate Delivers Attractive Inflation-Adjusted Returns; Historical Outperformance During Inflationary Periods

**Average Total Return During Different Inflation Regimes (1990-2023)[3,4]**




*Source: Cambridge Associates U.S. Real Estate Index, by S&P Dow Jones Indices, S&P 500 TR Index & DK Analytics*

## POTENTIAL TAX BENEFITS

Gains on sales of properties are typically taxed at lower long-term capital gains rates (vs. ordinary income tax rates) and depreciation deductions are applicable to real estate assets over its useful life. Therefore, private real estate has the potential to reduce an investor's effective tax rate, thereby enhancing after-tax returns.

## INCOME GENERATION

Real estate generates returns from both current income derived from rents/leases as well as capital appreciation from the increase in the value of an asset between acquisition and sale as a result of lease up, renovation, development, etc.

> "Opportunistic investments target unique, typically complex investments that require specialized and creative acquisition and management expertise to minimize risks and maximize the potential for higher returns."

## WHAT IS OPPORTUNISTIC REAL ESTATE?

Real estate has four primary strategies: core, core-plus, value-add, and opportunistic. When compared to other strategies, opportunistic real estate offers the highest potential returns, but may include risks. Among the risks are illiquidity, construction delays, environmental issues, shift in market demand and legal challenges. However, managers can help mitigate these risks with a well-diversified real estate portfolio with a range of strategies, property types and geographies.

| | |
|---|---|
| Typical Opportunistic RE Target Net Returns | 15% to 20%+ IRRs and 1.5x to 2.5x+ equity multiples; returns primarily from capital appreciation |
| Description | Properties requiring renovation, rehabilitation, development; stressed/distressed properties and situations |
| Considerations | Typically held in the private investment space through closed-end funds with terms around 10 years, which gives managers the flexibility to acquire, implement business plans, and exit assets |

Opportunistic investments target unique, typically complex investments that require specialized and creative acquisition and management expertise to minimize risks and maximize the potential for higher returns. This plays to the strength of real estate investors with experience, deep relationships, scale, and resources to access opportunities across sectors and geographies at the optimal time within a real estate cycle, and execute value-enhancing improvements in operational efficiencies and capital structures.

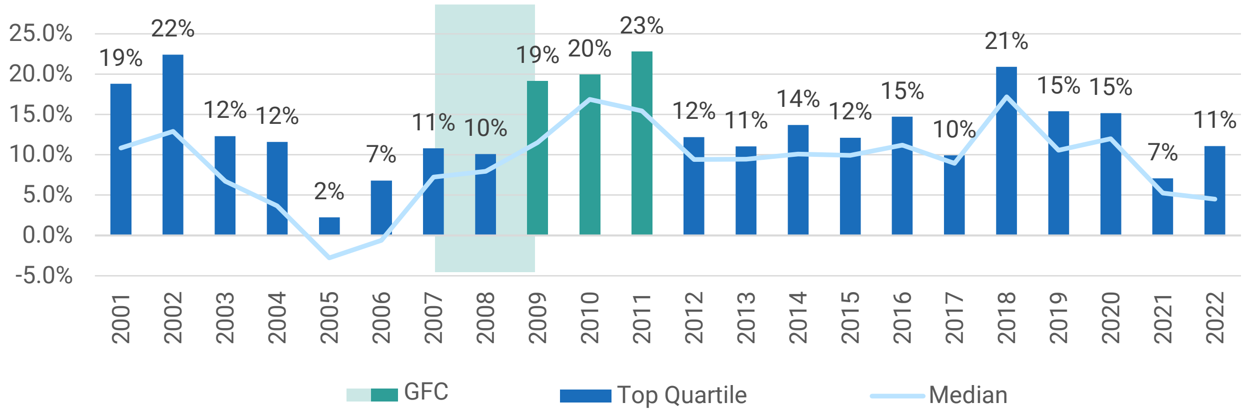
## WHY IS OPPORTUNISTIC REAL ESTATE INTERESTING NOW?

While there is a persistent opportunity to achieve opportunistic returns across market cycles, we believe that heightened market volatility and macroeconomic instability are creating opportunities to invest in assets and situations at advantageous entry points—a target-rich environment for distressed and special situations real estate assets.

Historically, non-core real estate funds have tended to generate higher risk-adjusted returns post-crises like the GFC. As such, investor conviction is on the rise. In Hodes Weill's 2023 Real Estate Allocations Monitor, a key finding from a survey of 175 global institutional investors was the belief that the next few years will prove to be good vintage years for deploying opportunistic capital.

### Peak Performance of Non-Core Real Estate Funds Occurred Post-Crisis (e.g., GFC)

**Opportunistic Real Estate Fund Returns Over Time By Vintage**[5]




*Source: Cambridge Associates Opportunistic U.S. Real Estate Index, by S&P Dow Jones Indices & DK Analytics*

The higher rate environment resulted in dislocations across private real estate from changes in valuations, lack of financing and reduced availability of capital. During a prolonged period of interest rates near zero, leverage across the sector increased meaningfully, with the value of commercial real estate loans at U.S. commercial banks nearly doubling over the last decade.[6] A bid/ask spread remains, which is causing decreased transaction values. Capital structures that were previously viable are becoming challenged, while financing alternatives are decreasing ahead of a significant increase in debt maturities. We believe even high quality assets may need liquidity to fill funding gaps for loan payoffs, refinancings and/or recapitalizations. Additionally, technological advancements and the lingering impacts of the COVID-19 pandemic have meaningfully altered demographic trends and social behavior—from how and where people live, work, and shop—which have had a substantial impact on real estate assets. Sectors that benefit from these changes may be able to produce real rental growth, which we believe may be rewarded with attractive rates of return. Conversely, sectors that are negatively impacted by these changes, or assets that are overleveraged due to the erstwhile widespread availability of low-cost financing, may experience stress or distress.

The consequences of the aforementioned market dynamics could create a wide variety of opportunities that will require different approaches to provide a combination of growth and value with downside protection and capital preservation. Within the context of the current environment, we've observed a few emerging investment themes that are worth highlighting due to their potential to produce attractive risk-adjusted returns.

| | Digital Infrastructure | Emerging Industrial | Capital Markets Dislocation |
|---|---|---|---|
| Themes | • Secular demand growth of data, ongoing investment in new facilities and tech transformation<br>• Capital required to support AI and cloud growth<br>• Land/power challenges create under supply | • Resilient e-commerce growth, low supply, submarket/subsector dynamics, supply chain evolution<br>• Growing shift in manufacturing and consumer behavior<br>• High replacement costs and cost of debt are slowing pace of new deliveries | • Funding gaps and broken capital structures requiring fresh capital<br>• Significant CRE loans maturing<br>• Money-losing sales of loans secured by various types of struggling commercial real estate are gaining momentum<br>• Deleveraging of real estate funds |
| Hypothetical Opportunities | • Acquire powered land with expansion potential and obtain permits/approvals for development<br>• Sell powered land or partner with an established developer to develop assets that meet hyperscale/enterprise requirements and pre-lease assets to investment grade tenants | • Acquire or develop assets in highly desirable locations at a discount to replacement cost<br>• Partner with an experienced owner/operator to develop and lease up assets as well as manage renovation projects to mark rents to market | • Acquire assets from over levered forced sellers in high barrier to entry markets<br>• Leverage operating partners' expertise to identify and prioritize key value creation workstreams, including reducing operating expenses, increasing occupancy, and driving rents |

## ABOUT DAVIDSON KEMPNER

Davidson Kempner is a global investment management firm with $37 billion of assets under management. Backed by over 40 years of experience, our global teams invest across the capital structure, applying our research-driven investment process to evaluate and execute a diverse range of transactions across asset classes, geographies and market cycles. We combine our opportunistic, event-driven approach with a disciplined focus on downside protection, serving as an established sponsor with a strong track record of value creation. Our Firm has over 500 employees across seven offices: New York, Philadelphia, London, Dublin, Hong Kong, Shenzhen and Mumbai. Additional information is available at: www.davidsonkempner.com.

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[1] Source: LaSalle (August 2023) Lasalle Global Real Estate Universe – Summary.

[2] Source: Sifma.Org (July 2024) SIFMA Capital Markets Fact Book 2024.

[3] High and low CPI periods are based on quartiles of the annual percentage change of the Consumer Price Index for All Urban Consumers (All Items U. S. City Average) from 1990 to 2023. The Low CPI bucket includes years with less than 1.7% inflation. The High CPI bucket includes years with 3.25% inflation or higher.

[4] The Cambridge Associates U.S. Real Estate Index contains the historical performance records of 984 institutional quality private investment funds with vintage years between 1986 and 2024. All data through March 31, 2024. This data (the "data") is the proprietary property of Cambridge Associates, LLC, S&P Dow Jones Indices LLC and/or their respective affiliates (together, the "Data Provider"). Cambridge Associates, LLC and/or its affiliates calculate and administer the data, but are not authorized as "administrators" under any relevant benchmark regulations or principles and the data cannot be used as a "benchmark" under such regulations or principles. The data has been licensed for use in connection with this paper, which is not sponsored, endorsed or promoted by the Data Provider. The Data Provider does not make any warranties or representations as to the accuracy, fitness for purpose or results to be obtained by using the data and disclaims all liability in this regard.

[5] The Cambridge Associates Opportunistic U.S. Real Estate Index contains the historical performance records of 408 institutional quality private investment funds with vintage years between 1988 and 2024. All data through March 31, 2024. This data (the "data") is the proprietary property of Cambridge Associates, LLC, S&P Dow Jones Indices LLC and/or their respective affiliates (together, the "Data Provider"). Cambridge Associates, LLC and/or its affiliates calculate and administer the data, but are not authorized as "administrators" under any relevant benchmark regulations or principles and the data cannot be used as a "benchmark" under such regulations or principles. The data has been licensed for use in connection with this paper, which is not sponsored, endorsed or promoted by the Data Provider. The Data Provider does not make any warranties or representations as to the accuracy, fitness for purpose or results to be obtained by using the data and disclaims all liability in this regard.

[6] Source: Board of Governors of the Federal Reserve System.