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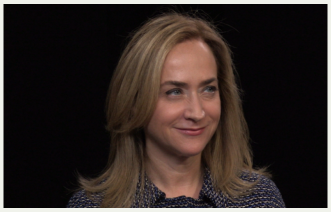
VIDEO SERIES

Briefing

Defining Core In 2015

An executive summary of the PrivcapRE video series "The Evolution of Core"



Cathy Marcus
Prudential Real Estate Investors

Sean Ruhmann
NEPC

Cherie Santos-Wuest

Defining Core in 2015

Key Findings

1. There needs to be an industry-wide understanding of core
2. Core assets have outperformed expectations
3. Multiples are high, but worth the cost of entry
4. Open-ended core funds are becoming popular again
5. REITs have a place in the discussion of core

The Panelists

Cathy Marcus
Global Chief Operating Officer,
Prudential Real Estate Investors

Sean Ruhmann
Partner,
Director of Real Assets Research,
NEPC

Cherie Santos-Wuest
Former Principal Investment Officer,
Real Estate,
Connecticut State Retirement
and Trust Funds

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1 THERE NEEDS TO BE AN INDUSTRY-WIDE UNDERSTANDING OF CORE

When it comes to defining the core subsector of private real estate, there are several meanings, depending on who you ask. "When people say they're a core investor or they're investing in a core product it doesn't mean the same thing to everyone," says Cathy Marcus, global chief operating officer at Prudential Real Estate Investors.

Most investors look at core as real assets with excellent fundamentals, but Cherie Santos-Wuest, former principal investment officer for real estate at the Connecticut Retirement and Trust Funds, says there are five key factors to defining core assets.

"The first is stable income," she says, adding that 75 percent of real estate returns should be coming from tenants with good credit. The other four principals that define core for Santos-Wuest are location in primary markets, new or newly renovated properties, low leverage (between 20 and 30 percent), and being a low- risk asset, meaning one that will sell easily in any cycle.

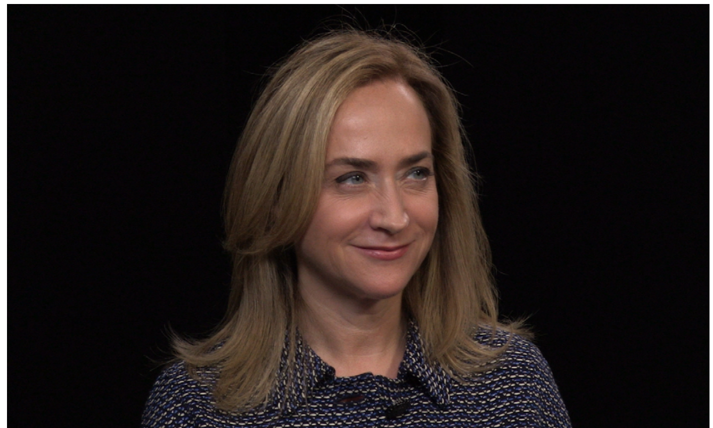
NEPC's Sean Ruhmann says core consist of properties that have "high tenant demand, consistently growing rents, and stable occupancies," and the ability to sell the asset relatively easily.

2 CORE ASSETS HAVE OUTPERFORMED EXPECTATIONS

In 2011 and 2012, when investors were putting dry powder back to work, core assets were still reeling from the global financial crisis. Many managers reluctantly put capital into core instead of distressed assets or non-core, believing that even at higher multiples, the risk was considerably less.

"I have been mildly surprised by the strength of our core investments," says Santos-Wuest. The Connecticut Pension and Trusts fund that she managed had a 50 to 60 percent target of core asset investments, and in order to reach that, she needed to commit another $750M to the asset class. The returns have been nearly 15 percent resulting from core, with a steady 5 percent from income. "I have to keep warning our investment committees that that is not going to continue,[that they need] to lower expectations back to around seven 7 percent returns," she says. "But the recent BlackRock study says there is still more in store for core."

One of the developments that contributes to that optimistic viewpoint of core assets has been the increase in new



It's All About Expectations

Cathy Marcus
Prudential Real Estate Investors

Setting investors' expectations is always a tricky proposition, particularly in good times, says Prudential Real Estate Investors' Cathy Marcus. "You shouldn't expect the same sort of run up that we've had," she says, referring to fifteen percent returns that many core real estate funds have had in the past two years. "If you look at markers like spreads to treasuries or spreads to corporate bonds, you feel pretty good about where the valuations are despite the fact that cap rates are low." Marcus says investors can still expect above average returns for at least two more years, but that they should temper expectations for the market to make a correction.

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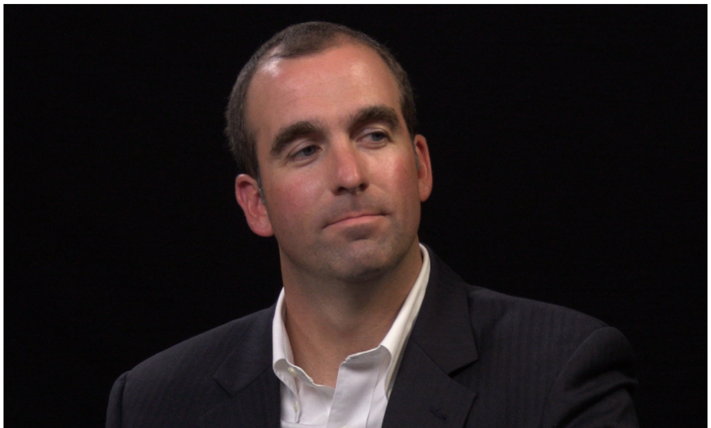

Core As Risk

Sean Ruhmann
NEPC

As core real estate in gateway or primary markets continue to trade at high multiples, core investing becomes a risky investment, despite the high returns in the latest few cycles. "We've really had a five plus year bull run," says NEPC's Sean Ruhmann. "We are trying to set expectations that if you are talking to a fund that's promising 20 percent plus returns they are probably talking a lot of risk today."

Ruhmann says he is recommending more value-add and opportunistic strategies to investors looking to diversify their portfolios with real assets, in order to ensure more durable income. "Returns might not be as good [as core], but today I would feel pretty good about getting a ten, eleven or twelve percent return out of a non-core fund."

construction. "The R-squared [a form of regression analysis] on that are really strong," says NEPC's Ruhmann. "We think there will be continued NOI [net operating income] growth for the next few years."

3 MULTIPLES ARE HIGH, BUT WORTH THE COST OF ENTRY

Increased competition for core real estate assets has made valuations spike, creating risk in an otherwise healthy sector of the market. Gateway and primary markets are strong and core assets within them have never been more competitive, but investors are not shying away at any cost, says Cathy Marcus of PREI.

"I'm not worried about valuations within core real estate, as long as your expectations are set appropriately," she says. Marcus says that in looking at the fundamentals from a growth expectation and supply perspective, things will continue to grow over the next couple of years, but investors should temper their expectations.

"There is a lot of capital in the space and that makes it harder to find good deals," says Ruhmann, adding that REITs are trading at very high funds from operations multiples. "That certainly makes us nervous, but when you look at other asset classes, everything is expensive."

The goal, says Marcus, is to try to avoid the auction-like core deals and competing with "the flavor of the month" investors. "You hope that operators and developers remember who has been a consistent reliable source of capital throughout the years," she says.

4 OPEN-ENDED CORE FUNDS ARE BECOMING POPULAR AGAIN

Real estate investments are generally structured as direct investments, REITs, joint ventures and separate accounts. But since 2012, investors have been lining up for open-ended core funds because of their greater access to liquidity and the flexibility to shift investments more easily.

"We execute our core strategy either through investing in open-ended core funds or separate accounts," says Santos-Wuest. "The benefit of open-ended core funds—in addition gaining access to larger acquisitions for less money—is that it allows us to manage our money. So from an asset management standpoint, we're actually using open-ended core funds almost as money market funds."

PREI's Marcus says that open-ended core funds are a product that a lot of managers like to run. "It's very stable and it gives you entry into larger markets and larger types of

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products and international investors," she explains. "Open-ended core funds serve as a starting point for first-time real estate investors who want instant diversification for their portfolios but also want time to observe market trends and learn about the space."

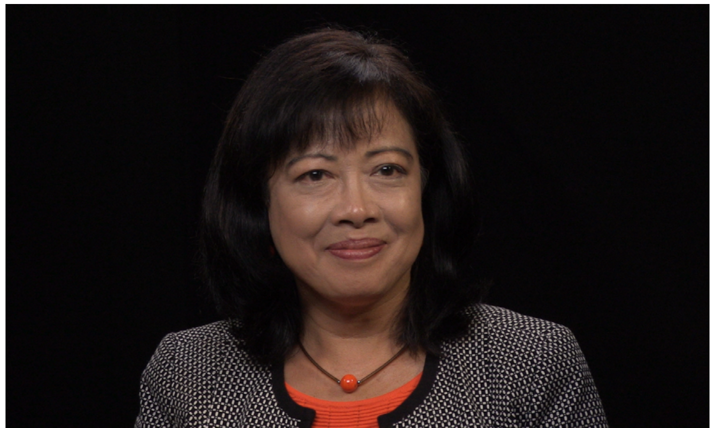
5 REITS HAVE A PLACE IN THE DISCUSSION OF CORE INVESTING

When structuring core real estate investments, while open-ended funds have become popular over the past two years, the incumbent Real Estate Investment Trust [REIT] is still a viable option that many investors find attractive, in spite of its illiquidity.

"When thinking about core real estate, what we're really thinking about is the underlying asset—the building," says Ruhmann. "And then we layer the structure through which you can access those buildings on top of that."

Ruhmann says core real estate is a long-term investment of between five and seven years, and, as a result, REITs own the same kinds of properties that are owned in a core fund. "In the short run, REITs do look like small-cap stocks, or they very much are volatile and correlated to equities," he says. "However, if you extend that hold period to five to seven years, they actually decouple from equities. And they look very much just like regular old core real estate."

But the involvement of REITs depends on how large an investment portfolio you have, says Santos-Wuest. "I could see how REITs could become part of a cash flow management issue if you pick the right REITs with the largest market cap." ■



Core Real Estate "Trifecta"

Cherie Santos-Wuest
Connecticut State Retirement and Trust Funds

One of the most attractive things about core real estate funds for institutional investors is they have the lowest management fees of any other real estate fund structure, says Cherie Santos-Wuest, former principle investment officer, real estate for the Connecticut State Retirement and Trust Funds. "You're hitting a trifecta of stable returns, high demand and low fees," she says, adding that core real estate represents "best in class" property. Santos-Wuest also advises investors to negotiate fees across all sub-strategies, not just core, in order to make investing more cost effective.

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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