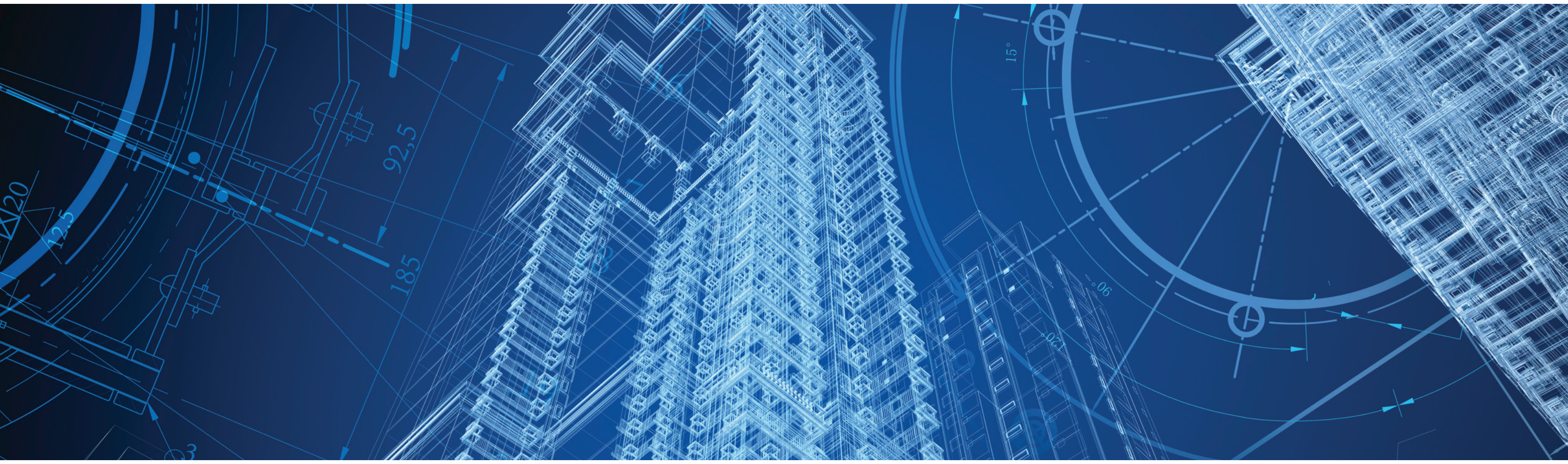
White Paper | December 2020

NEUBERGER | BERMAN



MATTHEW KAPLAN
Head of Almanac Realty Investors

MATTHEW WOLPERT, CFA
Portfolio Manager, Public Securities—Almanac Realty Investors

ROBERT SALISBURY, CFA
Director of Research—Almanac Realty Investors

Building a Better Model: Real Estate Company Investing

Unlike in most other business sectors, the vast majority of real estate enterprises are capitalized either building-by-building or portfolio-by-portfolio, with each newly acquired or developed asset going into a separate special purpose entity set up for the acquisition. Imagine a bank or an auto manufacturer setting up and capitalizing a separate company every time it expanded with a new branch or factory.

In our experience this model is inefficient, uneconomical, opaque and lacking in scalability, and often misaligns the interests of real estate operators and providers of capital. Consolidating assets and growing a real estate business within a single company overcomes many of these drawbacks and makes the asset class more attractive to investors—but it remains the exception rather than the rule.

In this paper, we outline the history of real estate company investing and how it works. We also explain why we believe that there are a number of reasons, both structural and related to current conditions, why real estate company investing is well positioned to become a favored way to structure real estate investments.

Executive Summary

- **The Origins of Modern Integrated Real Estate Operating Companies**
  – How tax reform, recession and regulatory change created a new environment in the late 1980s and 1990s
- **Why Create a Company? Alignment of Interest, Transparency and Efficiency**
  – The governance and alignment advantages of the corporate structure
  – The scale and efficiency advantages of a corporate balance sheet
  – The value-add that a strategic partner can bring to a real estate business, providing capital and corporate experience
- **How to Invest? Public or Private; Equity, Debt or Preferred Stock**
  – The variety of ways a capital partner can participate in a new operating company
  – Why we are flexible—but favor an investment of meaningful size, through debt or preferred stock, with split board control: investor seniority, investor-manager alignment and mutual trust
- **Which Operating Partners? Seasoned Teams, in Specialist Niches, With Skin in the Game**
  – The characteristics we look for in a real estate operating partner
- **What Is Our Outlook? Company Investing Is Built For Today's Uncertain Environment**
  – Why we believe the current crisis has accelerated the already growing interest in integrated companies: new appreciation of the efficiencies of the corporate balance sheet meets an inter-generational transfer of real estate assets

The joint stock company, with integrated ownership and operation of assets, has been around for centuries. The limitation of liabilities reduces the risks associated with building a business; its transparency helps interested parties to ensure fairness and alignment; and it enables businesses to take full advantage of the economies of scale. It is the structure used to carry out most of the major business activity of the modern world.

The big exception has been in real estate. In the U.S., the integrated real estate operating company had its birth as recently as 1986, with the passing of the Tax Reform Act.

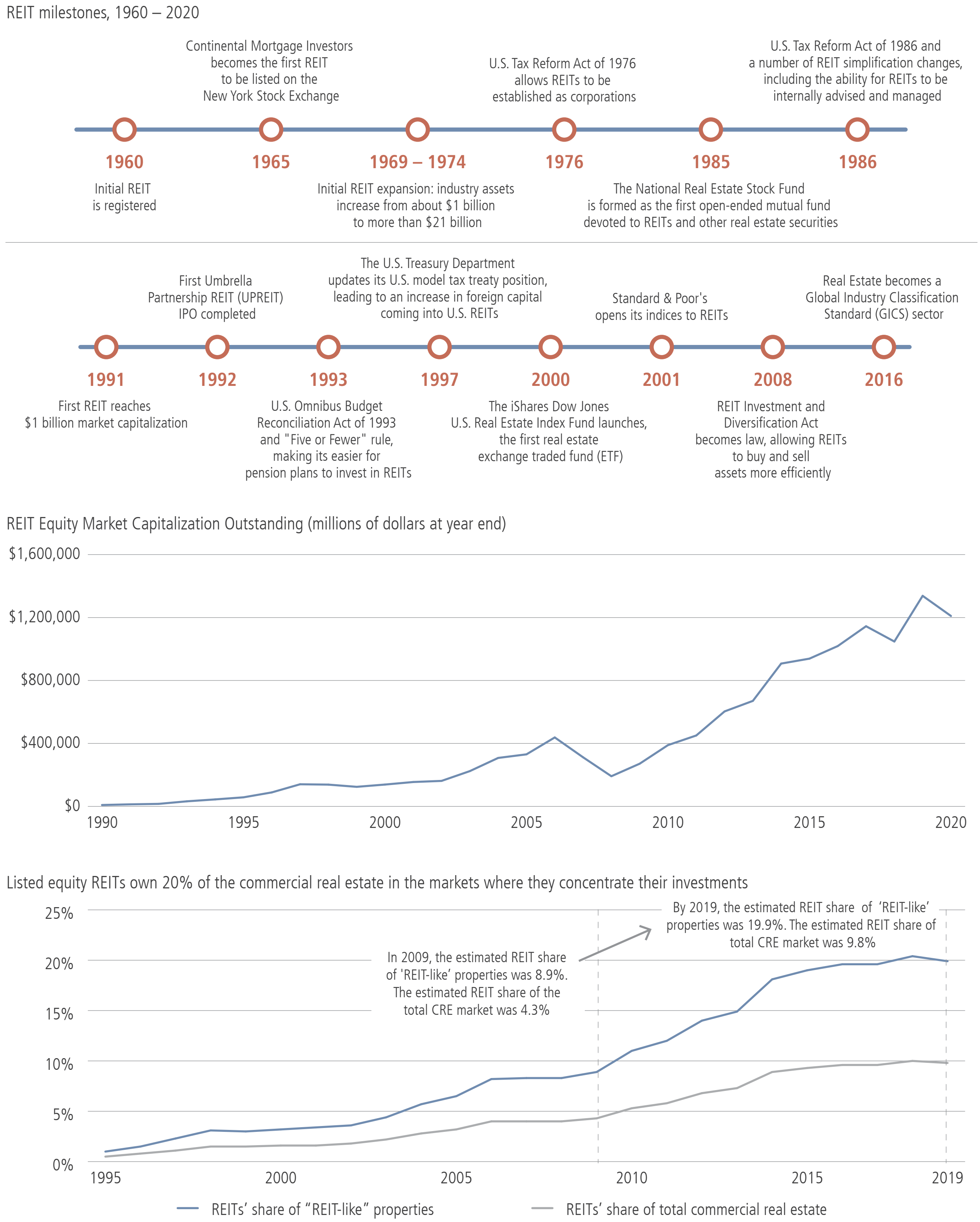
Before 1986, investing in real estate was largely about tax minimization. To qualify for various tax incentives, investors bought real estate assets through separate limited partnerships, and that forced them to expand building-by-building, partnership-by-partnership. The Tax Reform Act removed many of these incentives. With the multi-year Savings & Loan crises also starting in 1986, U.S. real estate endured a long recession.

When investor capital returned in the 1990s, with less tax incentive to take the limited partnership route, the industry saw the first stirrings of securitization and company formation. On the debt side, the government-owned Resolution Trust Corporation began to structure Commercial Mortgage Backed Securities (CMBS). And on the equity side, Real Estate Investment Trusts (REIT) boomed as the tax reforms of 1986 coincided with rule changes that enabled them to manage real estate as well as finance it (figure 1).

REITs have gone on to become a genuinely global asset class. They have been a part of the S&P 500 Index since October 2001. Today, there are 31 REITs in the Index and since 2016 they have been categorized as a distinct Global Industry Classification Standard (GICS) sector. Privately owned, non-listed integrated operating companies have also become far more prolific.

Nonetheless, according to NAREIT, these companies still own only 10% of U.S. real estate. As figure 1 shows, that rises to 20% when we focus on the higher-quality, institutional-grade properties that we would describe as "REIT-like," as opposed to broader commercial real estate assets. Some operationally intensive or specialized sub-sectors, particularly those that serve similar corporate tenants across different locations, have gone through more consolidation into companies. But vast, diverse, cash-flow oriented sub-sectors such as multifamily residential and industrial warehouse property remain very fragmented. On the whole, real estate across a variety of sub-sectors remains uniquely ripe for consolidation.

FIGURE 1. THE 60-YEAR HISTORY OF REITS



Source: Top: NAREIT. Middle: NAREIT, Bloomberg, Neuberger Berman. Data as of September 17, 2020. Based on the FTSE NAREIT All REITs Index and Almanac estimates. Bottom: CoStar, NAREIT.

FIGURE 2. THE ADVANTAGES OF THE INTEGRATED OPERATING COMPANY STRUCTURE

Company-level investing requires a broad-based approach including expertise in evaluating real estate management teams and company business plans, focus on underwriting corporate structures and securities, experience serving on boards and providing corporate governance.

	Typical Asset-Level Deal	Typical Almanac Company-Level Deal
ALIGNMENT OF INTEREST	• Operator is not required to provide significant co-investment • Operator earns a large promote if deals perform well, but operator does not lose meaningful capital if deals underperform • Operator focus is divided among multiple deals at once often with a variety of interests, and all compete for time, attention and resources	• Operators have a substantial portion of their own net worth alongside and/or subordinated to investors • Operators and investors are aligned in the ownership of a single entity, which owns both the management company and the real estate • Limited outside activities, minimizing conflicts and maximizing focus • Ability to invest in the management company and grow platform value
GOVERNANCE	• Investor rights primarily governed by contract • Investor rights vary depending on ownership • Investors may have minimal influence in key decisions	• Fiduciary board of directors provides broad oversight ensuring responsiveness, flexibility, efficiency and that investor interests are prioritized • Investment protections, including covenants and terms that limit downside • Ability to implement best practices across the broader portfolio
TRANSPARENCY	• Investors have limited visibility into operator and into the other properties that the operator owns • Deal-level reporting	• Full visibility into management team, personnel, structure, compensation, etc. • Property-level information as well as audited, consolidated GAAP financials
BALANCE SHEET	• Debt and equity capitalization occurs on a deal-by-deal basis, which may be inefficient, time consuming and confining • Capital availability is inconsistent • Does not provide operator with ability to take advantage of economies of scale	• Immediate access to capital for deployment, providing speed, certainty of close, and investment flexibility • Access to multiple forms of capital, including preferred equity, lines of credit and unsecured markets
SCALE	• Investors pay fees for leasing, financing, acquisitions and dispositions • Larger operator AUM might not lead to lower fees, purchasing power, investment in a team, etc. • Capital returned to investors upon exit, and each reinvestment requires a new structure	• Benefits of scale accrue to platform investors by lowering costs at the property level thereby maximizing profits of the company • Ability to add assets without incremental management fee costs • Capital can be recycled, allowing for compounding of profits
EXIT OPTIONALITY	• Assets are sold individually or as a portfolio into the private market • Larger portfolios may internalize management, but that is typically a misaligned transaction done at a high cost to investors	• Flexibility to exit in whole or in part in a large variety of ways: – Property-level sale of assets or portfolio – Portfolio-level recapitalization through refinancings or joint ventures – Company-level IPO, sale or financing

Source: Neuberger Berman. For illustrative purposes only.

Why Create a Company? Alignment of Interest, Transparency and Efficiency

There is no fundamental reason why all real estate investors should not benefit from company-level investing—and we believe those advantages are substantial for both real estate operators and providers of capital. They are summarized in the table in figure 2.

We argue that the most important gains are in alignment of interest between investors and real estate operators, and in governance and transparency more broadly. An integrated company is overseen by a fiduciary board of directors and comes with audited financial reporting. It puts the investor and real estate operator under the same roof as co-shareholders.

By contrast, in a typical special purpose vehicle structure, there is no obligation for a real estate operator to invest significant capital alongside other capital providers, nor any obligation to give capital providers governance oversight or report any financials beyond the level of the individual real estate deals. As such, there can be strong incentives for the real estate operator to collect fees while either ignoring downside risk or neglecting to enhance upside potential, particularly if one or more assets are affected by difficult market conditions.

Scalability is another big advantage of an integrated company. Creating a new special purpose vehicle to acquire or develop each new asset is not only complex and time consuming, it also makes it challenging to realize economies of scale and pass the benefits on to investors. A company-level balance sheet gives a real estate operator permanent capital on hand, making it easier to quickly compete for new opportunities. That capital can also be invested in improving the value of the company itself, by enhancing its operating capabilities. Furthermore, as the company monetizes successful projects, capital can be recycled back onto the balance sheet instead of being returned to investors who then would need to set up a new special purpose entity to reinvest. That makes it much easier to take the most efficient capital allocation decisions and achieve smooth compounding of returns.

What's in it for the real estate operators themselves?

We believe the potential benefits go far beyond the efficiency and resiliency gains that come with an integrated company balance sheet. With the right partner and structure, operators can access substantial capital while retaining control of their business, as well as bringing on board significant additional intellectual capital and experience.

Almanac Realty Investors, Neuberger Berman's company-level real estate investment team, has been investing in real estate companies for almost 25 years. It has occupied 73 seats on 46 public and private boards of directors. Our Managing Principals lead a 31-strong team, plus two senior advisors, with skills and experience not only in real estate investment management, including acquisition, development, leasing and construction; but also in capital markets, including corporate financing and restructuring, equity underwriting, debt financing and mergers and acquisitions; and in building and managing integrated companies. In addition to extensive contacts and relationships within the real estate ownership, financial services and private equity communities, the team maintains extensive relationships with intermediaries such as investment banks, mortgage brokers and financial advisors.

We believe this experience brings substantial added value to our chosen partners, from the beginning of our relationship, when assets are rolled up into the new integrated company in a tax-efficient manner and at fair value, to the end, when we seek to exit.

In a well-run integrated company, everyone has skin in the game and capital can be deployed far more efficiently.

How to Invest? Public or Private; Equity, Debt or Preferred Stock

Investment in real estate integrated operating companies can take a number of forms—public or private, debt or equity, and everything in between.

The common equity of REITs and other public real estate companies is liquid and freely traded. There are sometimes opportunities to make private placements of convertible debt or preferred stock in these entities, and investors can also build positions substantial enough to take them private. While public equity prices are broadly efficient over the long run, dislocations may occur that lead to opportunities.

There is arguably greater variety of opportunity in private companies. Investors can hold minority or majority interests in common equity, with or without representation on the board of directors and/or control over the business. Investors can make private placements of debt, convertible debt or preferred equity. There may be opportunities for "op-co/prop-co" joint ventures, similar to private equity co-investments, in which a property-owning partnership is established for a particular deal in collaboration with a company in which the investor has a stake. Exits can take the form of stated maturities on debt or the exercising of put rights, recapitalization of the underlying assets, or the sale of equity, debt or the entire company into the private secondary market or as an IPO.

FIGURE 3. ENTITY-LEVEL INVESTING: NINE DIFFERENT ENTRY POINTS

Source: Neuberger Berman. For illustrative purposes only.

At Almanac, we have taken exposure via each of these routes at one time or another. We believe flexibility is important as we help real estate operators set up integrated operating companies because they each require a different set of solutions. Many simply need growth capital; some are looking to take advantage of the efficiencies of a corporate balance sheet; others are family businesses that need to put together a deal that solves succession, tax and wealth-planning challenges. Those needs will go some way to determine how we invest: the size of our stake, our place in the capital structure, the extent of our control.

That said, in most cases we think the optimal balance of the investor's and manager's interests and strengths is achieved when we provide a meaningful proportion of the new company's total capital—on average, around 50 – 60%. Such a substantial commitment usually implies an investment through a mix of debt and preferred stock rather than common equity, for two reasons.

The first reason is chiefly for the benefit of us and our clients: it confers seniority in the capital structure commensurate with the risk of this size of commitment, which might include additional protective provisions such as change-of-control and anti-dilution rights or the right to "springing" board seats, which confer control of a company should certain covenants be breached.

The second reason is chiefly for the real estate manager's benefit. A 60% common equity investment would imply control of the board. While we think it is important to seek board representation and participation in corporate governance, we also believe that allowing the manager to retain split control of the board and the company, at least in the early years of the investment, is important for building confidence and trust in our partnership. We regard this as one of our differentiators as a substantial provider of capital to highly experienced management teams, as many investors making a similarly sized commitment would expect to take full control.

Which Investment Partners? Seasoned Teams, in Specialist Niches, With Skin in the Game

In addition to our preferences on structuring a deal, we also generally look for certain characteristics in the real estate operators we work with, as well as in their businesses and assets.

First and foremost, we look for established teams that have generated strong returns for themselves and their previous investors, with modest use of leverage and an emphasis on active management—that is, continuous enhancement of assets through acquisition, development and, where necessary, timely divestment. We also like to see a proven edge in a particular niche, whether that be product type or region or both, and a business plan that identifies growth opportunities within that niche.

We believe it is important to focus on continuity of a proven business strategy in a new integrated company: for example, while we might be prepared to capitalize expansion into multi-family residential properties in the Northeastern U.S. by a manager with a long track record in multi-family properties in the Midwest, or expansion into storage by a manager that has specialized in offices in the same suburb, we would be far less likely to support a foray into Midwest offices by a manager whose background is in Southeastern residential.

Real estate is a long-term business. On average, we have been invested in portfolio companies for five years, and we plan for six to eight years. Capital is generally being drawn down for new investment and development opportunities, followed by a multi-year period of maturation. Given the nature of these multi-year partnerships, it is important for us that the manager retains meaningful equity exposure, shares risk with us, and demonstrates a commitment to strong corporate governance.

What Is the Outlook? Company Investing Model Is Built for Today's Uncertain Environment

The coronavirus crisis has had a large and broad impact on the real estate industry, and we believe opportunities are likely to appear across a range of sectors. Entity-level investors like us can provide capital to real estate operators who can take advantage of the current market dislocation; offer rescue financing to meet the short-term liquidity needs of strong companies with high-quality assets; and pick up select REITs trading at depressed valuations in the public market.

In our view, however, the most interesting effect of current market conditions has been a noticeable uptick in real estate operators' interest in setting up an integrated company. Some of the operators we now see exploring this structure have been in business for decades without seeking an outside partner.

The huge uncertainty introduced by the coronavirus crisis reinforces the case for maintaining plentiful liquidity and a capital buffer—which becomes much easier and less costly with a company-level balance sheet. In defensive terms, it is easier to secure credit lines against a diverse, fungible portfolio of assets than it is to raise additional capital partnership-by-partnership. And for offense, when a manager anticipates a full pipeline of investment opportunities coming from distressed sellers, it is advantageous not to have to negotiate loans with banks, building-by-building. Ready access to capital offers the nimbleness required to act upon these opportunities, which can result in more favorable terms; and capitalizing a company with an experienced, well-connected partner can enhance the deal flow itself.

We believe the crisis is accelerating a pre-existing, structural trend.

The industry is capital-intensive with long cycles and characterized by dynastic family businesses. As a result, it can sometimes appear slow-moving. But these same forces can also unleash rapid and substantial change. Real estate businesses that were founded 30 or 40 years ago, during the growth years of the 1980 and 90s, are today led by entrepreneurs in their 60s, 70s and 80s. As businesses pass to younger family members, the basis cost used for the assessment of capital gains tax is "stepped up" to today's market value. When properties have been appreciating for decades, this can make a huge difference to potential tax exposure. That is a strong new incentive for inheritors to sell or recapitalize those assets, particularly if they can do so by creating a company that allows them to retain some ownership and control as well as enhancing the overall efficiency of the underlying business.

Conclusion: An Approach Whose Time Has Come

Most of the world's industries attract capital by organizing themselves into integrated operating companies with flexible balance sheets. These entities are efficient, transparent and designed to align the interests of management and investors through tried-and-tested governance structures.

Much of the world's real estate business still falls outside of these structures. That is partly due to the tax incentives that survived into the mid-1980s, and partly due to the diversity and capital intensiveness of the industry's asset base and its historical ownership profile. But the integrated real estate operating company has now demonstrated its advantages over three decades: in some more easily consolidated sectors it has become the dominant model, and in the form of the REIT it has started to emerge as a genuinely global asset class. Over recent years we have been joined as investors in the sector by large institutional asset managers and banks as well as pension funds, sovereign wealth funds and endowments.

We believe that the uncertainties and opportunities created by the coronavirus crisis are incentivizing real estate operators to find ways to access capital and liquidity more efficiently. We see more and more of them seeking out trusted partners who can bring capital and experience to help their hard-won businesses be resilient over the coming years. These unforeseen dynamics reinforce what we see as a longer-term trend toward building entity-level real estate businesses.

For all of these reasons, we believe that the U.S. real estate industry is on the brink of widespread recognition that companies provide the best model for investment. There has never been a more exciting time to provide the capital and the skills required to create new real estate integrated operating companies.

Index Definitions

The **FTSE EPRA/NAREIT Global Real Estate Index** Series and its subset, the **FTSE EPRA/NAREIT Developed Index** Series, are designed to represent general trends in eligible real estate equities worldwide. Relevant activities are defined as the ownership, trading and development of income-producing real estate. The **FTSE EPRA/NAREIT USA Index** is a subset of the **FTSE EPRA NAREIT Developed Index**.

NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com