Why Private Real Estate?

A Closer Look Inside an Asset Class that Offers a Range of Potential Benefits for Investors

BENEFIT STREET PARTNERS

Why Invest in Private Real Estate?

As the third-largest investable asset class, real estate is a vital part of the investment universe. Commercial real estate (which by definition includes multifamily, office, retail, healthcare, industrial, and other property types) represents 17% of the U.S. investment market, according to Nareit, an organization that represents the real estate investment trust (REIT) industry.[1] But, for many investors, real estate remains a relatively small portion of their investment portfolio, and is often misunderstood.

While publicly traded REITs are the most well-known real estate investment vehicle structure, these publicly traded stocks are far from being the only way for investors to access the growth, income-generation, and diversification potential of real estate.

Private real estate (PRE) is a major—but not well understood—component of the overall real estate market. Given its size, the range of opportunities and benefits it offers, PRE is a structure that financial advisors and their clients cannot afford to ignore. The primary benefits investors seek with PRE include:

- Investment diversification through lower exposure to public equity markets
- Potential for growth and income
- Lower volatility that drives attractive risk-adjusted returns
- Possible protection against inflation

There are many different ways to access PRE—from non-listed diversified funds to single-property investments—presenting financial advisors with a variety of opportunities to find the right mix of strategies, vehicles, and managers to meet their clients' goals.

1. Nareit, "REIT Quick Facts for Financial Professionals, 2019-2020." For details, see www.reit.com/quickfacts.

TOPICS COVERED IN THIS E-BOOK:

Real estate as an asset class: allocation recommendations and performance

How PRE differs from public real estate

How investors can access PRE

Recent developments in the PRE market

Common misconceptions about PRE

What drives PRE performance

Benefits of PRE for investors

Benefits of active management

How to identify quality managers

What Defines Private Real Estate

It is often said that private real estate is "real estate that acts like real estate," rather than acting like publicly traded securities—a common criticism of publicly traded REITs.

PRE may often be an institutional-quality investment that is offered via an array of strategies and vehicles. PRE typically encompasses the same property types as publicly traded real estate, with the primary differences being how investments are funded as well as distinct liquidity and volatility characteristics inherent to privately-held, non-traded securities.

The most common property types held in PRE strategies include:

- Residential/Multifamily
- Office
- Retail
- Industrial
- Net Lease (invests in properties where tenant pays a combination of property taxes, insurance, and maintenance)

	PUBLIC	PRIVATE
FUNDING	Initial and secondary offerings directly to investors	Capital raised via private offerings to institutional and individual investors
TRADING	Shares listed on exchange and traded continuously during exchange hours	Trading is not permitted; liquidity is typically provided at set intervals (monthly, quarterly, annually)
VALUATIONS	Based on traded share price; shares typically trade at a premium or discount to NAV	Based on property fundamentals
CORRELATION	Historically has tighter correlation to overall public equity markets	Typically lower correlation to public equity markets
DIVIDENDS	Quarterly or monthly distribution	Varies by vehicle

How Investors Can Access Private Real Estate

As is the case with all private asset classes, it is important for advisors and their clients to understand the various vehicles that can be used to access private real estate. PRE is available via an array of investment options, from institutional closed-end funds to diversified private funds, interval funds and private REITs, as well as direct investment in a single-property limited partnership or development deals.

Historically, access to PRE for individual investors has largely been limited to accredited investors, but recent developments have changed that. For example, the growing popularity of interval funds has provided non-accredited investors a way to access PRE through vehicles having lower investment minimums and periodic liquidity provisions. Additionally, many non-traded REITs are open to non-accredited investors.

COMMON PRE INVESTMENT VEHICLES

CLOSED-END FUNDS

A type of mutual fund investment structure; after IPO, shares traded in the open market; not to be confused with closed funds, closed-end funds remain open for investment

PRIVATE REITS

Privately offered fund, often Reg D; open to only accredited or qualified investors; usually higher minimums

INTERVAL FUNDS

A type of investment fund structure; after IPO, shares may price on a daily basis; not to be confused with closed funds, closed-end funds remain open for investment

PRIVATELY OFFERED, PUBLICLY REPORTING REITS

A privately offered REIT that files its financials and operational information publicly due to SEC requirements

NON-TRADED REITS

SEC-regulated but not exchange-listed; typically open to non-accredited investors; may offer relatively low minimums; may charge higher fees

SINGLE-PROPERTY LIMITED PARTNERSHIPS

More direct approach to real estate investing; often involves a small group of investors; proxy for direct property ownership; often known as "country club" deals

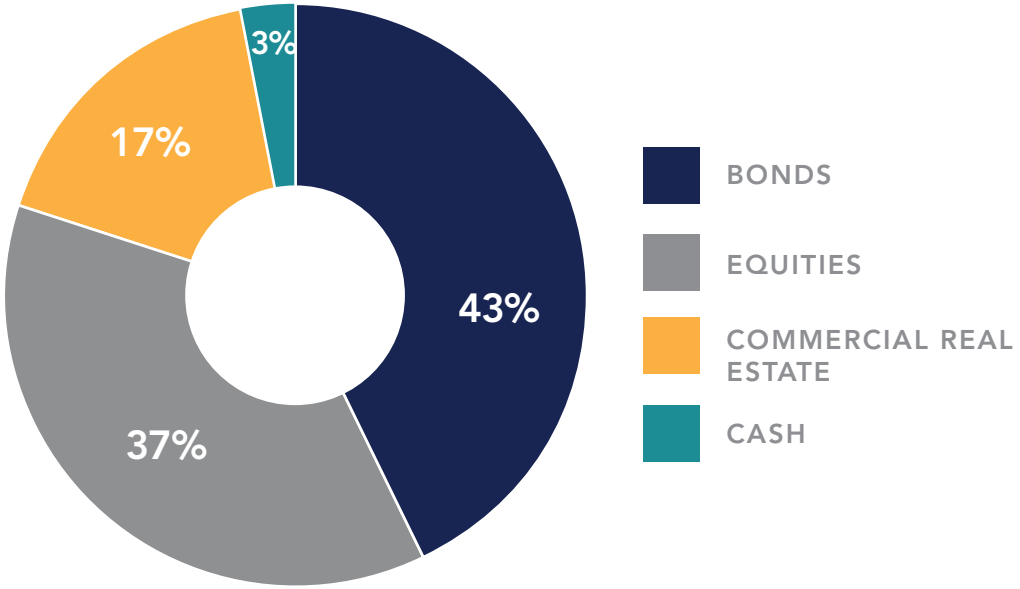
Determining the Appropriate Real Estate Allocation

How much should investors allocate to commercial real estate in their portfolios?

Of course, the answer depends on each specific investor's objectives, risk tolerance, cash flow needs and time horizon, among other considerations. It is likely that commercial real estate is underrepresented in many investors' portfolios.

According to Nareit, multiple studies have found that the optimal investor portfolio allocation to REITs, one of the most popular ways for individuals to access the commercial real estate investment marketplace, may be between 5% and 15%.[1] In fact, David F. Swensen, Ph.D., the CIO of Yale University and the author of Unconventional Success: A Fundamental Approach to Personal Investment, recommends a 15% allocation to REITs for most investors. This figure closely aligns with commercial real estate's share of the overall U.S. investment market.

SHARE OF THE U.S. INVESTMENT MARKET



Sources: Nareit, "REIT Quick Facts for Financial Professionals, 2019–2020." Stock and bond data from Board of Governors of the Federal Reserve, Financial Accounts of the United States, 2018Q4; commercial real estate market size data based on Nareit analysis of CoStar property data and CoStar estimates of Commercial Real Estate Market Size, 2018Q4.

1. Nareit, "REIT Quick Facts for Financial Professionals, 2019–2020." Examples of studies within the stated range include: Ibbotson Associates, Morningstar, and Wilshire Funds Management.

Historical Data About the Benefits of REIT Investing

REITs represent one of the most well-known—and well-researched—ways to invest in real estate, whether through publicly traded or private vehicles. Although REITs represent only a portion of the PRE universe, data about REIT performance provides a useful window into the potential benefits of investing in real estate through diversified funds.

Based on extensive analysis of Morningstar® Fact Sheets, Nareit found that REITs have delivered the following benefits for investors historically[1].

Compared to other stocks, bonds, and T-Bills

Traded REITs provided the largest increase in wealth over a period of 47 years[2]

Adding traded REITs to a hypothetical portfolio

Increased portfolio returns with no increase in risk[3] and reduced the risk of retirees outliving assets[4]

REITs have provided

Stable income despite inflation and market fluctuations[5]

Past performance is no guarantee of future results.

1. Data sourced from Nareit, "REIT Quick Facts for Financial Professionals, 2019-2020." For details, see www.reit.com/quickfacts.
2. Nareit. For details, see www.reit.com/quickfacts.
3. Nareit. For details, see www.reit.com/quickfacts. Risk was calculated by annual standard deviation. Standard deviation measures the fluctuation of returns around the average return of the investment. The higher the standard deviation, the greater the variability (and thus risk) of the investment returns.
4. Nareit. For details, see www.reit.com/quickfacts.
5. Nareit. For details, see www.reit.com/quickfacts.

Recent Developments in Private Real Estate

Since the financial crisis, the real estate market has undergone significant structural changes in terms of valuation processes, return expectations, investment vehicle structures, number of investment sponsors, and participation by high net worth and retail investors.

This is particularly true for PRE, with most of these changes providing meaningful benefits for investors. Still, many financial advisors and their clients harbor misconceptions about PRE likely based on outdated assumptions.

As a result, now is an excellent time for advisors and their clients to learn more about the current real estate landscape and revisit PRE as an asset class.

CHANGES IN THE PRE MARKET OVER THE PAST DECADE:

- Meaningful reductions in fees, as many of the higher fee managers have exited the market
- Additional investment choices, including new fund structures and vehicles that enable greater access for non-accredited investors
- Shift in ownership of a large amount of real estate to private investors with long-term objectives, contributing to lower volatility and a more stable investor base
- Better education about real estate performance expectations, awareness of where we are in the real estate market cycle, and how that impacts returns

Common Misconceptions About Private Real Estate: **Volatility and Risk**

PERCEPTION
All PRE is highly levered and high risk.

REALITY
PRE provides a range of leverage and risk levels.

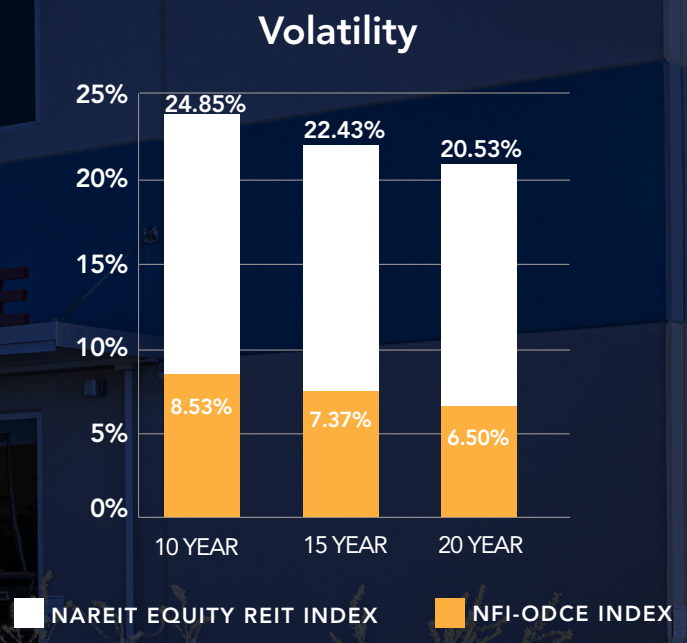
Private real estate is not a one-size-fits-all structure for the asset class. PRE supports a range of strategies used by managers, inclusive of leverage and presents risk levels appropriate for a variety of investors seeking an array of objectives.

While some PRE strategies use high amounts of leverage, others use higher equity investment and lower leverage.

Public REITs are valued real time by trading in the market; private funds are not. The less frequent (often monthly or quarterly) PRE net asset valuations, based on periodic property valuation/appraisals and asset level mark-to-market, may demonstrate lower pricing volatility. Valuation methodologies, the publishing of pricing data and purchase intervals can also vary significantly from manager to manager within private real estate.

Volatility of Private Real Estate vs. Public Real Estate

The standard deviation of public REITs (as measured by the Nareit Equity REIT Index) has been significantly higher than that of private real estate (as measured by the NFI-ODCE Index).



Source: Nareit

Common Misconceptions About Private Real Estate: **Liquidity**

PERCEPTION

PRE is highly illiquid.

REALITY

PRE provides varying degrees of liquidity by vehicle structure and fund.

While it is true that private real estate securities do not trade on the open market, some PRE offerings provide liquidity. In fact, the PRE market offers shareholders a range of liquidity profiles which may match their individual capital needs and investment timelines.

The ability to purchase each PRE fund and the subsequent liquidity is determined by the offering structure and rules of each individual fund. Funds offer daily, monthly, quarterly, and "capital call" purchases. PRE and interval funds have predetermined redemption periods, typically at monthly or quarterly intervals. Traditional closed-end funds, however, typically carry longer lockup periods and require "liquidity events" to return capital to investors.

Common Misconceptions About Private Real Estate: **Fees**

PERCEPTION

PRE has high fees and investment minimums.

REALITY

PRE strategies can be accessed via vehicles with lower fees and lower investment minimums.

The private real estate market offers a range of strategies that vary in cost. While some PRE fund sponsors offer options with seven-figure investment minimums and high management fees due to the objective, property type, or fee structure, there are also many more affordable investment options.

The massive correction in the real estate market a decade ago forced managers utilizing fee structures that weren't aligned with investors' interests out of the market. Since then, a fundamentally driven recovery of the real estate market, combined with investor pressure, has led PRE managers to offer funds with a range of fee structures and investment minimums that have expanded access to and the affordability of PRE.

"The massive correction in the real estate market a decade ago forced managers utilizing fee structures that weren't aligned with investors' interests out of the market."

Drivers of Real Estate Performance

One of the primary benefits of investing in PRE is the opportunity to access a source of returns and income that isn't directly tied to the forces driving performance in the public equity and fixed income portions of investors' portfolios.

PRE performance is tied primarily to the performance of the underlying properties, fees, and additional economic factors. Compared with public REITs, PRE has much less sensitivity to capital flows, public equity markets, interest rate trends, and overall investor sentiment.

	PUBLIC	PRIVATE
CAPITALIZATION RATES	Investor yield can vary significantly from the cap rate of the underlying assets	Yield closely reflects the cap rate of the underlying assets
VALUATIONS	Can vary significantly from the fund's NAV due to public market trading volatility and investor sentiment	May more closely reflect the actual value of the fund's underlying holdings
SENSITIVITY TO INTEREST RATES	Highly sensitive to changes in interest rates and fixed income market trends	Historically demonstrates less sensitivity to changes in interest rates and fixed income market trends than public funds
SENSITIVITY TO PUBLIC EQUITY MARKETS	Valuations are largely driven by supply and demand and capital flows in public equity markets	Low sensitivity to public equity markets (valuations driven by actual underlying asset pricing)

Benefits of Investing in Private Real Estate

Historically, PRE has provided a range of benefits for investors. Here are four of the most common benefits investors seek to gain by adding PRE to their portfolios:

LOWER CORRELATION TO PUBLIC MARKETS: Real estate can be a valuable source of diversification. Within real estate investment types, PRE provides even greater opportunities for allocation than public REITs. Public REITs are highly correlated to public equity markets and quite sensitive to interest rate changes. Conversely, PRE's longer-term investment horizon and less frequent pricing make it less susceptible to such unrelated market factors, with pricing derived from the actual value of the underlying real estate.

POTENTIAL FOR GROWTH + INCOME: One of the most compelling advantages of private real estate is that it provides opportunities for both growth of capital and consistent income generation—within an asset class with relatively low levels of volatility. Whether a strategy is focused primarily on one form of those return generators or the other depends on the strategy's investment objectives, vehicle structure, and leverage levels. This flexibility allows advisors to guide their clients to managers and vehicles that align with the investor's goals and risk tolerance.

LOWER VOLATILITY AND HIGHER RISK-ADJUSTED RETURNS: The long-term nature of PRE investment is typified by potential for consistent income generation and stable net asset values. In turn, PRE's lower volatility relative to public REITs has historically led to competitive risk-adjusted returns.

HEDGE AGAINST INFLATION: Inflation is one of the biggest long-term threats to an investor portfolio. PRE historically has proven to be a reliable store of value. Because rents and property values can be highly correlated to the Consumer Price Index, real estate may provide a natural hedge against inflation. Over time, income (or yield) generated from PRE has more than kept pace with the rising cost of living.

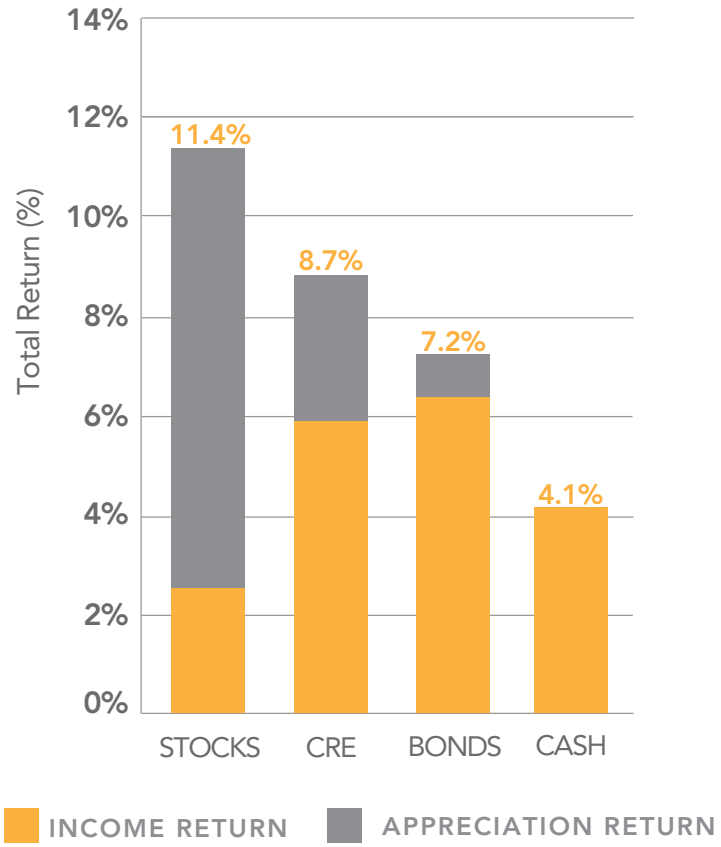
PRE Benefit: Lower Correlation to Public Markets

Real estate can be a valuable source of diversification for an investor portfolio.

Real estate reacts differently across economic and market cycles than other asset classes, such as stocks and bonds. When used as part of a well-diversified investment portfolio, real estate should reduce overall volatility and be additive to returns.

Within real estate investment vehicles, PRE may provide even greater opportunity for diversification than public REITs. Public REITs are highly correlated to public equity markets and quite sensitive to interest rate changes. Conversely, PRE's longer-term investment horizon and less frequent pricing make it less susceptible to non-correlated factors, including the public equity markets. When held in a diversified portfolio of investments, these attributes of PRE should further reduce portfolio volatility and correlation to public markets.

AVERAGE ANNUAL RETURNS SINCE 1980



Source: CoStar Group, www.costar.com; Stocks returns are represented by the S&P 500 Index, CRE returns derived from the NCREIF NPI Index, an unlevered index of institutionally owned U.S. private equity real estate, bond returns from the Barclays Capital U.S. Aggregate Index, and cash returns from three-month Treasury Bill Rates.

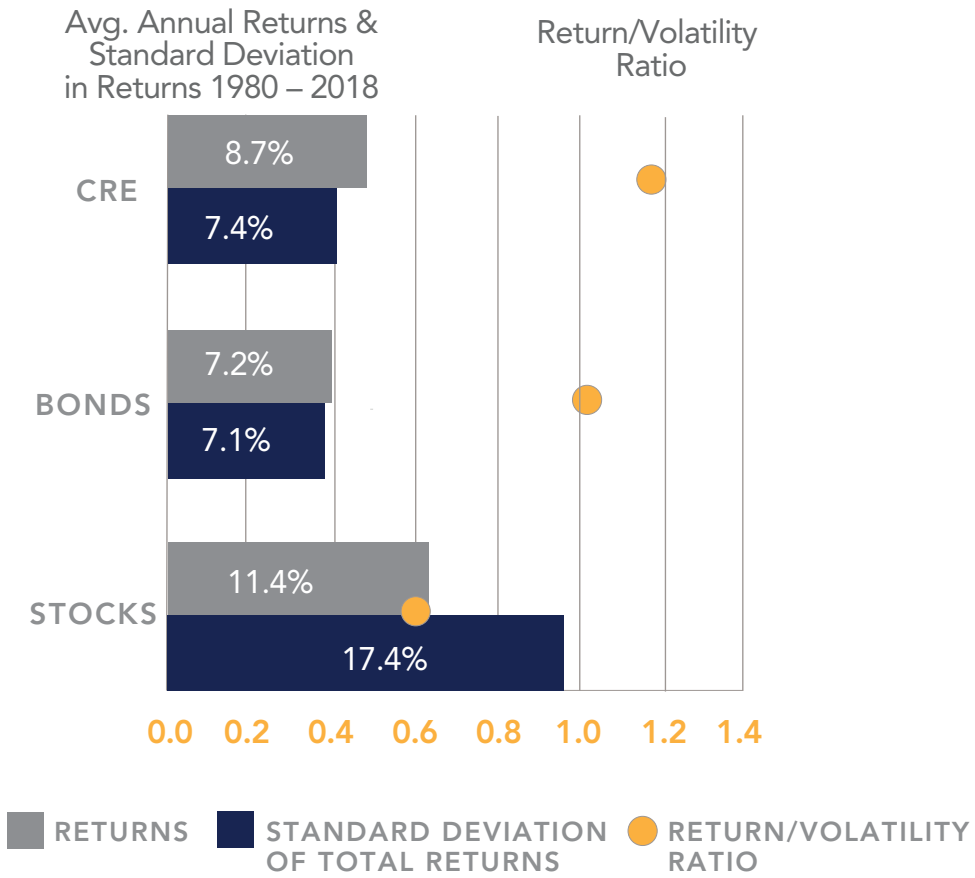
PRE Benefit: Income, Growth—or Both

One of the most compelling advantages of private real estate is that it provides opportunities for both growth of capital and potential for consistent income generation—within an asset class with relatively low levels of volatility.

Whether a strategy is focused primarily on one of those return generators or both depends on the strategy's investment objectives, vehicle structure, and leverage levels. This structural and composition flexibility allows advisors to guide their clients to managers and vehicles that align with the investor's goals, risk tolerance, and timeframes.

The long-term nature of PRE may support consistent income generation and more stable net asset values. In turn, PRE's lower volatility relative to public REITs has historically led to competitive risk-adjusted returns.

RETURNS & VOLATILITY ACROSS ASSET CLASSES



Source: CoStar Group, www.costar.com

How Active Management Adds Value in Private Real Estate

Given its long-term investment horizon and the array of strategies and vehicle types, PRE provides a myriad of opportunities for skilled, active management teams to create value for investors.

The PRE universe includes many institutional-quality managers that oversee distinct strategies that are tailored to their strengths including knowledge of specific property types, regions, and investment vehicles.

SOURCING ACQUISITIONS: Through relationships with brokers and developers, PRE managers can identify attractive investment opportunities that are coming to market.

UNDERWRITING: A PRE manager's knowledge of the risk factors and growth drivers of specific markets and property types can lead to more effective underwriting based on precise cap rates and financial modeling/projections.

ASSET & PORTFOLIO MANAGEMENT: An adept manager can add value by constructing a diversified portfolio of various asset types across diverse regions. Skilled acquisition teams can identify specific properties within those categories displaying the most attractive and complementary characteristics.

PROPERTY MANAGEMENT: Once properties have been acquired, a PRE manager can enhance the value of those assets by making appropriate capital improvements, optimizing rental pricing, and managing vendors and tenants.

INVESTOR COMMUNICATIONS & REPORTING: By providing timely and detailed information about the performance of the overall portfolio and individual properties, as well as insights about new investment opportunities in the pipeline, PRE managers can help investors and advisors properly position PRE within an investor's broader investment objectives.

DEBT & EQUITY CAPITAL MARKETS: Ability to raise equity capital and maintain consistent inflows while working with debt capital sources (banks, private placements, etc.), all in an effort to maintain targeted leverage while growing the fund.

How to Evaluate Private Real Estate Sponsors

As with any active investment strategy, manager selection is paramount with PRE. Given the diversity of strategies, vehicle types, and managers within PRE, financial advisors often perform extensive due diligence before recommending that their clients invest in PRE.

Properly evaluating a PRE manager requires asking the right questions to determine whether that manager is the right fit for an investor's objectives, risk tolerance, and overall portfolio. Advisors should also educate clients about the role that PRE plays in a diversified portfolio and set appropriate expectations about the investment's performance.

The process of manager evaluation and educating clients is an opportunity for advisors to showcase the value they bring to investors, especially relative to accessing alternative asset classes such as PRE.

BENEFIT STREET PARTNERS

QUESTIONS TO ASK WHEN EVALUATING PRE MANAGERS:

What property types, lease structure, and regions do you invest in? Why do you focus on those properties and regions?

In which aspect(s) of the investment process do you expect to add the most value?

How diversified is the portfolio? Besides diversification, what other risk-management techniques have you implemented?

What is your performance track record? Is that net of all fees? In addition to absolute and risk-adjusted performance, what is your correlation to other asset classes?

How repeatable and expandable is your performance?

Who are the professionals who make up the investment and client service team? What is their industry experience?

What level of transparency do you provide into your investment process?

Do your funds have third-party validation?

What steps have you taken to ensure alignment of interests between investors and fund managers? How much sponsor capital do the managers or sponsors have invested in the fund?

How are your fees structured?

What are your procedures for auditing, governance, and data security?

Understanding—and Accessing—a Diverse Asset Class

Thanks to the underlying fundamentals of the real estate market and structural changes that have occurred to real estate investment vehicles in the past decade, private real estate has emerged for individual and institutional investors alike, providing significant opportunities for investors of all sizes to strengthen their portfolios.

But PRE is not an asset class that can be understood or appreciated at a 30,000-foot level. To identify the best opportunities and implement them properly within an overall portfolio, investors and their advisors need to understand the various types of strategies, vehicles, and managers that provide access to PRE—as well as the drivers of performance within each fund.

Furthermore, simply providing clients exposure to real estate as a broad asset class—possibly via publicly traded REITs—may forgo some of the most valuable diversification and return-generating characteristics of real estate. Rather, investors need to explore various ways to access the asset class—and the breadth of today's PRE investable universe provides ample opportunity to do so.

To learn more about private real estate and strategies, please do not hesitate to contact us by visiting our website at www.bspmultifamilytrust.com.

Potential Benefits of Private Real Estate

1. Low correlation to public markets
2. Capital growth + a consistent stream of dividend income
3. Lower volatility and higher risk-adjusted returns than public REITs
4. Hedge against inflation