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MEMORANDUM

TO: Meketa Clients
FROM: Meketa Investment Group
DATE: March 17, 2020
RE: COVID-19 Update: Effects on Real Estate

Over the past few weeks, you have received several updates from Meketa related to the COVID-19 pandemic and its impact on the markets. Here, we focus on some of the implications specific to the institutional real estate asset class.

Goethe wrote, "Enjoy when you can, endure when you must." After enjoying an unprecedented bull market, we are now in an uncertain and dynamic environment, and endurance is required. Commercial real estate is historically a long duration asset. Keeping that in mind provides ballast to our perspective and guides our decision making.

While private real estate typically experiences the fallout of negative economic events on a lagged basis, we may not see this effect to the extent we have in the past. Each day brings fresh news of closings (MGM hotels and casinos in Las Vegas, bars and restaurants in many major cities) and social distancing guidelines that immediately and materially reduce people's visitation to and interaction with commercial spaces. Combine these immediate changes in real estate usage with a sustained and material impact on the broader US economy and we should expect repercussions to the commercial real estate sector, specifically to valuations, during the next 6 to 12 months. The flow through of performance and valuation impairments may occur more quickly still, given the integration of various technologies and data-enabled platforms into commercial real estate investing, valuation, and reporting since the global financial crisis.

Within multi-strategy portfolios, it is important to focus attention on the amount of leverage utilized in non-core transactions, as this will magnify the changes in net asset value compared to core properties. Notwithstanding the lowering of base interest rates, the lending markets have not stabilized, and illiquid securities such as commercial mortgages may not be easily re-financed. Similarly, real estate debt funds, which have been leveraged to enhance return, will also show larger volatility as their NAVs are re-marked.

Very few property types and locations are fully immune to the negative economic conditions currently unfolding. While the duration of leases matters, and sectors with shorter lease terms will feel the pain much more quickly than those with longer lease terms, public policy and guidance in this pandemic environment is having disruptive impact irrespective of lease term or structure. Indeed, the most vulnerable real estate to the COVID-related demand disruption are the more discretionary social spots like restaurants, movie theaters, and gyms that are now closing or subject to restricted hours of operation. Hotels are experiencing real time impact from widespread travel restrictions, group business cancellations, and a drop in leisure demand.

Looking further out, social distancing may accelerate the work-from-home and e-commerce trends, putting further pressure on brick and mortar retail and office demand. Prolonged supply chain interruption may even impact the darling industrial sector. Meketa expects a pronounced slowdown in new single family residential mortgage originations despite the low rates, as credit committees go into lockdown, if they have not already. Shelter in place will equal rent in place.

On the disposition side, the window for attractive exits has closed and it is uncertain when new crossing prices will be established. Investment managers will need to adjust their models accordingly. Maintaining liquidity and continuity of tenant income is priority one.

Those investors with business models anchored in core/core-plus strategies and other conservative investment approaches are better positioned to weather this crisis. Conservative leverage, ample reserves, a focus on high-quality assets and markets, an absence of speculative development, and a focus on durable lease income will all work to bolster a portfolio's resilience. Partners with strong fiduciary mindsets, deep resources and a long operating history offer an additional line of defense.

As always, Meketa encourages investors to remain focused on the long-term, avoid hasty asset allocation decisions based on temporary asset values and be prepared to be opportunistic. Disruptions create opportunities, and investors who look forward and position themselves to take advantage of the likely opportunities will enjoy superior investment performance. Some of these may include the secondary market to acquire interests from involuntary sellers, debt securities that can be purchased at meaningful discounts to par, and certain REIT shares, both preferred and common, whose trading prices are significantly below replacement costs and whose management and balance sheets are time tested and deep

Meketa will continue to provide regular updates on our views of the markets as they relate to commercial real estate investments. In the interim, if we can offer any assistance or guidance, please reach out.

Most importantly, stay safe and stay healthy!

Disclaimers